Supreme Court, U.S.
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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1995

**DEAN WITTER REYNOLDS INC.,**
**a corporation,**

*Petitioner,*

v.

**HUDSON T. HARRISON and HARRISON**
**CONSTRUCTION INCORPORATED, a corporation,**

*Respondents.*

**On Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit**

## PETITION FOR WRIT OF CERTIORARI

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141 pp

## QUESTIONS PRESENTED

I. Whether a broker-dealer is liable under the control person provisions of Section 20(a) of the Securities Exchange Act for fraudulent acts committed in personal transactions between an employee and a noncustomer of the broker-dealer where the acts have already been determined as a matter of law to be outside the actual authority, apparent authority, or scope of employment of the employee.

II. Whether the reliance element of a Securities Exchange Act Section 10(b) violation can be satisfied by alleged reliance on an employment relationship, where it has already been determined as a matter of law that the plaintiff knew or should have known that the employee's actions were outside any actual authority, apparent authority, or scope of employment of the employee.

## LIST OF PARTIES

Petitioner:

Dean Witter Reynolds Inc.

Respondents:

Hudson T. Harrison

Harrison Construction, Incorporated

The following is furnished in compliance with Supreme Court Rule 29.6:

Dean Witter Reynolds Inc.

Parent Company: Dean Witter, Discover & Co.

Subsidiaries (except wholly owned)—SPS Transaction Services, Inc.

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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1995

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**DEAN WITTER REYNOLDS INC.,**
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v.

**HUDSON T. HARRISON and HARRISON CONSTRUCTION INCORPORATED, a corporation,**

*Respondents.*

---

**On Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit**

## PETITION FOR WRIT OF CERTIORARI

## OPINIONS BELOW

The opinion of the United States Court of Appeals for the Seventh Circuit is reported at 79 F.3d 609 (7th Cir. 1996), and is reprinted in full in the appendix hereto at App. 1 to App. 24.[1] The opinion of the United States District Court for the Northern District of Illinois, Eastern Division, dated March 20, 1995, is reported at 1995 U.S. Dist. LEXIS 3571, and reprinted in full in the appendix hereto at App. 25 to App. 53. A previous opinion of the United States Court of Appeals for the Seventh Circuit in this case is reported at 974 F.2d 873 (7th Cir. 1992), and is reprinted in full in the appendix hereto at App. 59 to App. 87. The opinion of the United States District Court for the Northern District of Illinois, Eastern Division, dated June 28, 1989, is reported at 715 F.Supp. 1425 (N.D. Ill. 1989), and is reprinted in full in the appendix hereto at App. 90 to App. 118.

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[1] References to sequentially numbered documents included in the Appendix attached hereto will be cited as (App. ___). References to the sequentially numbered documents included in Dean Witter Reynolds Inc.'s Separate Appendix filed in the United States Court of Appeals for the Seventh Circuit, incorporating portions of the Record on Appeal, will be cited as (S. App. ___).

## JURISDICTION

The judgment of the United States Court of Appeals for the Seventh Circuit was entered on March 20, 1996. Petitioner's petition for rehearing was denied on May 20, 1996. (App. 55).

The jurisdiction of this Court is invoked pursuant to 28 U.S.C. §1254(1).

## STATUTES INVOLVED

The statutes involved in this case are set forth in full below.

Securities Exchange Act of 1934, Section 20(a), 15 U.S.C. §78t(a):

> Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such

> controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

Securities Exchange Act of 1934, Section 10(b), 15 U.S.C. §78j(b):

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

## STATEMENT OF THE CASE

Respondent Harrison, a wealthy businessman, entrusted money to two individuals, Kenning and Carpenter, who gave him their personal promissory notes and promised to share with him their returns from a purported scheme of investing in municipal bonds. (App. 4-5). Kenning and Carpenter were account executives employed in petitioner Dean Witter's Boca Raton office. (App. 4). Harrison was never a customer of Dean Witter. (App. 7, 79-80, 83). The funds he entrusted to Kenning and Carpenter were transmitted by checks to them personally—sent either to their homes or to Carpenter's personal bank account. (App. 7-8). Harrison never sent any communication to Kenning and Carpenter at Dean Witter's office. (S. App. 65-66). His name did not appear on any Dean Witter records. (*Id.*) He never received from Dean Witter any payments, account statements or other communications. (*Id.*); (App. 7-8). Kenning and Carpenter furnished Harrison with IRS 1099 forms showing Carpenter—not Dean Witter—as payor of the amounts remitted to Harrison from time to time as payments on the promissory notes. (App. 8, 32).

The story Kenning and Carpenter told Harrison was that Kenning, as a large producer, was favored by Dean Witter with the opportunity to invest personally in discounted municipal bonds on favorable terms (including low mark-up and commissions) that yielded exceptional returns when the bonds were called. (Reflecting the promised returns, the promissory notes given to Harrison bore interest rates ranging between 18 and 60 percent on an annualized basis.) (App. 4-5, 60). In offering to share this supposed opportunity with Harrison, Kenning explained that the program would not be available to Harrison if he were to become a customer of Dean Witter. Rather, Harrison was told that Kenning and Carpenter could only purchase the bonds in their employee trading accounts at Dean Witter. (App. 5).

No municipal bonds were ever purchased. Instead Harrison's funds (along with funds obtained from other subscribers to the scheme) were used by Kenning and Carpenter for personal expenditures, trading in stock options, investments in private start-up companies and a horse farm. (App. 8). Less than half of the funds obtained were used to trade in stock options in Carpenter's Dean Witter account, in which large losses were sustained. (S. App. 119-128; 137-141).

The heavy volume of trading in Carpenter's account caused Dean Witter's compliance department to make an inquiry through the local branch manager, Frost. Frost questioned Kenning and Carpenter and thereafter required that all investments in Carpenter's account be prepaid. (App. 6-7; 74-75).

Dean Witter's rules forbade employees from receiving any checks in their own names and required screening of all incoming and outgoing mail. (S. App. 95a-95d; 97-99). Kenning and Carpenter successfully evaded this supervisory process by having Harrison deliver funds at home or to their personal bank accounts. (App. 7-8).

Kenning and Carpenter eventually flew to Illinois, where Harrison lived, and confessed that they had lost all his money. Harrison then sent letters to Kenning and Carpenter demanding immediate payment of all sums due on the outstanding notes. (S.App. 59; 135-36). He did not notify Dean Witter of his losses nor demand payment from Dean Witter until the filing of this action. (App. 95).

Harrison's action against Dean Witter sought recovery on three theories: (1) respondeat superior, (2) negligence, and (3) violation of Rule 10b-5, for which Dean Witter was allegedly liable as a control person under Section 20(a) of the Securities Exchange Act. The district court granted summary judgment in Dean Witter's favor on all three theories. 715 F.Supp. 1425 (N.D. Ill. 1989) (App. 90 to 118). The court of appeals affirmed as to the first two theories but reversed as to the claim based on Section 20(a). 974 F.2d 873 (7th Cir. 1992) (App. 59 to 89).

As to plaintiffs' respondeat superior theory, the court of appeals ruled that the undisputed facts failed to show actual or apparent authority or that Kenning and Carpenter were acting within the scope of their employment or that the transaction appeared to be regular and in the ordinary course of business. To the contrary, the court said,

> We cannot nor can any reasonably prudent person naturally suppose that Kenning and Carpenter possessed the authority to use the employee account for Harrison's benefit. It is simply not believable that their authority would extend so far. Furthermore, Harrison's transactions with Kenning and Carpenter were not regular on their face and could not appear to be within the ordinary course of business . . . .

974 F.2d at 884 (App. 80).

As to plaintiffs' theory that Dean Witter was negligent in hiring and retaining Kenning and Carpenter, the court of appeals held that on the undisputed facts there was no duty-creating relationship between Dean Witter and Harrison, and therefore Dean Witter could not be liable to Harrison even if it had been negligent. 974 F.2d at 885 (App. 83).

On the issue of Section 20(a) liability, however, the court of appeals thought the district court had mistakenly believed that "culpable" participation was necessary to establish the requisite "control." 974 F.2d at 880 (App. 71). The correct test, it held, was whether the putative control person had actual control over the "operations [of the wrongdoers] in general" and the "power or ability to control" the specific transaction constituting the primary violation. 974 F.2d at 873 (App. 72). On this test, according to the court, the facts did not permit summary judgment for the defendant, either as to the existence of control or as to Section 20(a)'s good faith defense. The court therefore remanded the case for trial on Section 20(a) liability. This Court denied certiorari. 509 U.S. 904 (1993).

At trial it was necessary for the plaintiffs not only to establish the "control" necessary to satisfy Section 20(a) but also to prove a predicate Rule 10b-5 violation, including the element of "justifiable reliance." Harrison's counsel argued to the jury that Harrison was justified in relying on Kenning and Carpenter's story because Dean Witter had vested them with the "trappings" of Dean Witter employees. (S. App. 117-118).

The jury found in favor of the plaintiffs and the district court denied defendant's motions for judgment n.o.v. and for a new trial. (App. 53). Judgment was entered against Dean Witter for an amount which, with interest, exceeds $6.5 million. (App. 54).

With respect to the "justifiable reliance" element of the alleged Section 10(b) violation, the district court was troubled by the apparent inconsistency of allowing that requirement to be satisfied by the mere existence of an employment relationship when it had been determined as a matter of law that the plaintiff could not reasonably rely on the employees' claim of authority nor reasonably consider the transactions as within the ordinary course of business. (App. 38). Quoting the court of appeals' finding on this point, the district court stated:

> Such a finding presents a powerful argument that Harrison could not show justifiable reliance and perhaps the Seventh Circuit could have affirmed the summary judgment on this basis. It did not do so, however, so this Court was left to follow the mandate and the opinion which plainly directed this Court to present the § 20(a) claim to the fact-finder.

(App. 38 n.4).

The court of appeals affirmed. *Harrison v. Dean Witter Reynolds Inc.*, 79 F.3d 609 (7th Cir. 1996) (App. 1). On the "control" issue, the court found that the existence of control over Kenning and Carpenter's fraudulent acts was satisfied, notwithstanding that those acts took place outside of Dean Witter's business, because more diligent supervision of Kenning and Carpenter might have led to uncovering their scheme before it collapsed. On the reliance issue, the court observed that its prior finding of no apparent authority was made "only" regarding respondeat superior liability and that "reliance under the [Securities Exchange] Act involves other considerations." *Id.*, 79 F.3d at 617 (App. 17). The opinion did not explain what "other considerations" warranted not giving binding effect to its prior finding on the reliance issue.

## REASONS FOR GRANTING THE WRIT

Certiorari should be granted because the decision of the court of appeals raises an important question concerning the meaning and scope of "control person" liability under the federal securities acts, a form of vicarious liability on which this Court's decisions provide no direct guidance despite the recurring importance of control person liability in the administration of the implied private right of action under Section 10(b) of the Securities Exchange Act of 1934. The decision of the court of appeals is inconsistent with the strong trend of this Court's decisions against enlarging Section 10(b) liability beyond the clear mandate of the statute, a principle manifested most recently in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. ___, 114 S. Ct. 1439 (1994).

## I.

## THE DECISION OF THE COURT OF APPEALS SUBJECTS BROKERAGE FIRMS TO VICARIOUS LIABILITY AS "CONTROL" PERSONS FOR FRAUDS COMMITTED BY EMPLOYEES IN PERSONAL TRANSACTIONS.

The natural meaning of the word "control" does not permit describing an employer or principal as having control over any and every act done by a dishonest employee or agent no matter how far outside the actual authority, apparent authority, or scope of employment of the wrongdoer the act may be. The principal has neither legal nor practical authority to direct or "control" acts of an agent that are unknown to the principal and that take place outside the principal's business. Mere "status" as an employee or agent is not the equivalent of control over everything the employee or agent does. Unless Congress used the term "control" in Section 20(a) in an arbitrary and artificial sense, the language of the statute does not impose liability on the principal merely by virtue of the employment relationship.

The decision below, however, effectively makes the mere existence of the employment relationship a sufficient basis for finding control person liability, casting on the defendant the burden of establishing the affirmative defense of "good faith." If the "ability to control the specific transaction or activity" is satisfied on facts like those in this case, where the crucial transactions occurred outside the business and outside the scope of employment, it is hard to conceive of employee activities that would be deemed beyond the employer's "ability to control." The true basis of "control" liability as interpreted by the court below therefore appears to be simply the status of the actor as an employee of the "control" person.

The opinion of the court below leaves little doubt that this was the court's interpretation of Section 20(a). The court stated that its interpretation "does not make the broker-dealer an insurer," but the court's explanation of why the broker-dealer is not an insurer is just that Section 20(a) "provides the alleged controlling person with an affirmative defense which, of course, that person has the burden of proving." 79 F.3d at 614 (App. 12).

The existence of an affirmative defense does not support an interpretation of the word "control" broader than the word itself means. The question is what prima facie liability Section 20(a) imposes, not what affirmative defenses there may be. The correct interpretation of liability-imposing language of a statute is not determined by inquiring what affirmative defenses may exist. It would be no answer to an overbroad reading of "control person" to say that the a defendant may be able to assert the statute of limitations or *in pari delicto* as a defense. It is no better an answer to say that the defendant may show "good faith" as a defense. A defendant has the burden of proving an affirmative defense. The burden of proving control should be on the plaintiff.

"It is inconsistent with settled methodology in § 10(b) cases to extend liability beyond the scope of conduct prohibited by the text." *Central Bank of Denver v. First Interstate Bank*, *supra*, 114 S. Ct. at 1448. The liability imposed on Dean Witter in this case does not flow from Dean Witter's control over, or failure to exercise control over, the fraudulent activities of Kenning and Carpenter. It is based, as the opinion below clearly shows, simply on Dean Witter's failure to detect those fraudulent activities. But nothing in the language or legislative history of Section 20(a) suggests that it was intended to impose on broker-dealers the duty of serving as a detective, for the benefit of the world at large, with respect to whatever fraudulent dealings its employees might have with persons other than its customers. Such an imposition of vicarious liability extends far beyond even the "aiding and abetting" theory of liability that this Court rejected in *Central Bank*.

No legislative history supports reading "control" liability as broadening an employer's liability so as to include acts for which the employee would not be liable under respondeat superior. The legislative history suggests that the main reason for Section 20(a) was to extend liability to other persons, such as controlling shareholders and corporate officers, who would not be liable under respondeat superior. *See Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1577 (9th Cir. 1990), *cert. denied*, 499 U.S. 976 (1991). Nor can such an expansive vicarious liability be supported by referring to the beneficent policy objectives of the securities acts, as did the court below ("We have long viewed the statute as remedial, to be construed liberally . . .",) (974 F.2d at 880) (App. 72), and other court of appeals opinions on which it relied. *See SEC v. First Securities Co.*, 463 F.2d 981, 987 (7th Cir.), *cert. denied*, 409 U.S. 88 (1972); *Myzel v. Fields*, 386 F.2d 718, 738 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *Metge v. Baehler*, 762 F.2d 621, 630 (8th Cir. 1985), *cert. denied*, 474 U.S. 1057 (1986); *Hollinger v. Titan Capital Corp., supra*, 914 F.2d at 1573 ("The very nature of the vast securities business, as it has developed in this country, militates for such a rule as public policy . . ."). This Court has rejected such "policy" reasons for broad construction of the securities statutes in a series of opinions, most recently in the *Central Bank* case. *See*

114 S.Ct. at 1444, 1446-7, 1453-4; and *see Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 200 (1976); *SEC v. Seaboard Corp.* 677 F.2d 1301, 1311, n.12 (9th Cir. 1982).

Certiorari should be granted so that this Court may make clear that Section 20(a) of the Securities Exchange Act does not make a broker-dealer a control person with respect to all acts of an employee or registered representative.[2] Liability based on a supposed duty to detect fraud perpetrated on strangers—i.e., noncustomers—no doubt makes the civil remedy more far-reaching, as this Court observed in the *Central Bank* case, but "it does not follow that the objectives of the statute are better served." Rather, such extensive liability "exacts costs that may disserve the goals of fair dealing and efficiency in the securities markets." *Id.*, 114 S.Ct. at 1454.

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[2] The proposition that broker-dealers *are* control persons with respect to every fraudulent act of an employee or registered representative is not only implicit in the decision of the Seventh Circuit in this case but has been expressly adopted by the Ninth Circuit. *Hollinger v. Titan Capital Corp.*, *supra*, 914 F.2d at 1574: "The facts are not in dispute that Wilkowski was a registered representative associated with Titan. Accordingly, Titan was, as a matter of law, a 'controlling person' under § 20(a) with respect to Wilkowski."

## II.

## THE DECISION OF THE COURT OF APPEALS PERMITS PLAINTIFFS WHO KNOW OR SHOULD KNOW THAT THEY ARE DEALING WITH FAITHLESS AND DISHONEST EMPLOYEES TO USE RELIANCE ON THE PRINCIPAL AS AN ELEMENT OF THE CLAIMED SECTION 10(B) VIOLATION.

The breadth of the "control person" liability endorsed by the court of appeals in this case is compounded by the court's treatment of the required reliance element.

The existence of a Section 10(b) violation is an essential predicate for vicarious liability under Section 20(a). Reliance is an essential element of a Section 10(b) violation. *Central Bank*, *supra*, 114 S.Ct. at 1449. "Allowing plaintiffs to circumvent the reliance requirement would disregard the careful limits on 10b-5 recovery mandated by our earlier cases." *Id.*, 114 S.Ct. at 1450.

On the first appeal of this case, the court of appeals held that, as a matter of law, plaintiff Harrison could not be treated as having relied on any apparent authority of Kenning and Carpenter or on the proposed transaction's being in the course of Dean Witter's business. 974 F.2d at 884 (App. 80). Nevertheless, at the ensuing trial of the alleged Section 10(b) violation plaintiffs relied on the employment relationship of Kenning and Carpenter with Dean Witter to establish the required element of reliance. (App. 31-32). In considering whether that aspect of the case required setting aside the verdict, the district court recognized that the court of appeals' ruling was a "powerful argument" that the plaintiff could not show justifiable reliance. (App. 38 n.4). The district court felt constrained to disregard the incongruity of verdict, however, because the court of appeals had directed that the case be tried. (*Id.*) [3]

It its second opinion the court of appeals, in an apparent reference to the district court's dilemma, stated that the district court had dealt with the case "as best the prior mandate of this court could be understood and applied." 79 F.3d at 613 (App. 9). However, the court of appeals did not directly address the incongruity perceived by the district court. It said only that "Some of the same considerations [bearing on reliance] may also apply in a *respondeat superior* state claim context, but reliance under the Act involves other considerations as well." 79 F.3d at 617 (App. 17). The court did not explain what "other considerations" justified disregarding the established fact that the plaintiffs knew or should have known that Kenning and Carpenter were acting outside any conceivable authority from Dean Witter.

This anomalous result further illustrates the problems inherent in an interpretation of the "control person" provision of Section 20(a) that makes the employer prima facie liable for any fraudulent act committed by an employee, whether in the course of his employment or not. Given such a premise, it is but a small step to assuming that the employment relationship also supplies the reliance element of the Section 10(b) violation. The result is that two provisions of the statute, not just one, are circumvented or stretched in order to reach a result perceived as desirable on grounds of public policy.

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[3] Of course neither the court of appeals nor the defendant had reason to anticipate that the plaintiffs would in effect treat respondeat superior as the basis for their claim of reliance.

## CONCLUSION

For the foregoing reasons, Petitioner Dean Witter Reynolds Inc. respectfully urges this Court to grant its Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit.

Respectfully submitted,

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# APPENDIX

# IN THE
# UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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No. 95-1970

HUDSON T. HARRISON and
HARRISON CONSTRUCTION, INC.,

*Plaintiffs-Appellees,*

*v.*

DEAN WITTER REYNOLDS, INC.,

*Defendant-Appellant.*

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Appeal from the United States District Court
for the Northern District of Illinois, Eastern Division.
No. 86 C 8003—**George M. Marovich**, *Judge.*

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ARGUED DECEMBER 6, 1995—DECIDED MARCH 20, 1996

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Before HARLINGTON WOOD, JR., and KANNE, *Circuit Judges*, and SHARP, *Chief District Judge.**

HARLINGTON WOOD, JR., *Circuit Judge.* This securities fraud case charges a violation of Section 10(b) of the Securities Exchange Act of 1934 (the Act), 15 U.S.C. § 78j(b), and Section 20(a) of the Act, 15 U.S.C. § 78t(a). This panel is acquainted with the case, but different issues are raised in this second appeal. In the first appeal, 974 F.2d 873 (7th Cir. 1992), *cert. denied*, 113 S. Ct. 2994 (1993) (*Har-*

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* The Honorable Allen Sharp, Chief Judge of the Northern District of Indiana, sitting by designation.

*rison I*), we affirmed in part and reversed in part. The case had come to us on the grant of summary judgment in favor of defendant Dean Witter with respect to the claim raised under Section 20(a) of the Act. We reversed the grant of summary judgment and remanded for trial concluding on the question of control that:

> The alleged facts are sufficient to prevent our finding, as a matter of law, either that Dean Witter did not actually exercise control over the operations of Kenning and Carpenter in general or that Dean Witter did not possess the power or ability to control Kenning and Carpenter's transactions upon which the primary violation is predicated. Accordingly, it was error to grant Dean Witter's motion for summary judgment on the basis that Dean Witter was not a controlling person. We leave that determination to the factfinder.

974 F.2d at 881.

We further concluded on the issue of the conduct of Dean Witter that:

> Under the alleged facts of the present case we cannot say, as a matter of law, that Dean Witter acted in good faith and neither directly nor indirectly induced the act or acts constituting the violation. This determination, too, must be left to the factfinder.

*Id.* at 882.

As to Harrison's original *respondeat superior* theory of liability, which has now disappeared from the case, we held that the district court exercising its diversity jurisdiction had correctly found that Dean Witter was not liable under *respondeat superior* for the state law vicarious liability claim which Harrison raised. The statutory issue arising under the federal act is now argued by Dean Witter to be governed by the prior ruling of this court on the *respondeat superior* state claim. Also gone from the case is the claim for the alleged negligent hiring of the two employees of Dean Witter directly involved.

Since *Harrison I*, a jury has found on all issues against Dean Witter and assessed damages. We now review that final judgment.

## *ISSUES*

Dean Witter raises three issues which must be addressed: *First*, Dean Witter argues that the district court erred in denying Dean Witter's motion for judgment as a matter of law on the question of control person liability. Dean Witter claims there was no legally sufficient evidentiary basis for the jury to find "control person liability" under Section 20(a) of the Act. In its view there was no showing that Dean Witter had the power or ability to control the particular transactions that allegedly violated Section 10(b) of the Act. *Second*, Dean Witter alleges the district court erred in denying its motion for a new trial on the basis that the evidence was insufficient for the jury to have found the justifiable reliance necessary to establish a primary securities fraud in violation of Section 10(b). *Third*, Dean Witter claims the district court erred in denying its motion for a new trial based on the exclusion by Judge Marovich of certain income tax evidence related to Harrison. Dean Witter argues that the excluded evidence was relevant to all three principal issues in this appeal.

## *FACTUAL SUMMARY*

In addition to the facts outlined in the first opinion reversing the grant of summary judgment, the jury in this case heard the fraud story in greater detail and, as always, had the opportunity to assess the credibility of the witnesses and to determine the weight to be accorded their testimony.

There is no dispute that Harrison was defrauded by John Kenning, a vice president of Dean Witter, and by John Carpenter, a registered salesperson for Dean Witter. Kenning, the more experienced in the brokerage business, was responsible for Carpenter, then twenty-seven years old, being employed by Dean Witter in 1983. When Kenning was hired by Dean Witter he insisted that Dean Witter also take his friend Carpenter as a "package deal." Richard Frost, Dean Witter's Boca Raton branch manager, bought that package, and trouble. Both Kenning and Carpenter worked closely together in that branch office. A couple of years after being hired, the two pleaded guilty in 1986 in federal court in Florida, admitting the fraud which constitutes the basis for this civil suit.[1] Over a hundred other persons besides Harrison were similarly defrauded, but Harrison's loss, the biggest of any of the defrauded investors, was found by the jury to be $3.4 million, to which the court added an additional $3.1 million prejudgment interest.

Kenning explained his view of how their successful fraud worked, for awhile. Kenning told his victims that because of his position as vice president at Dean Witter, and Carpenter's as salesperson, they were allowed to buy municipal bonds at advantageous prices through a special municipal bond investment program offered by Dean Witter for its large brokers. It was claimed by Kenning and Carpenter that the municipal bonds which could be bought through them were very good investments. When originally issued, he explained, the bonds had been discounted. Furthermore, when the municipal bonds would later be called, sometimes at a premium, it would be on a tax-free basis. Kenning further testified that he led Harrison to believe that he was able to take down large blocks of municipal bonds which he could share with Harrison because of his high production for Dean Witter, his general stockbroker ability, and because of his position as vice president.

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[1] Kenning received two consecutive four-year sentences and Carpenter a single four-year sentence.

Carpenter's account at Dean Witter though not also in Kenning's name played a part in their fraudulent activities. Kenning and Carpenter were investing their clients' money through this account, which they labelled a "trading account," but not in municipal bonds as they pretended. Instead, they were investing in riskier "put" options for themselves. They hoped to achieve greater returns through these personal riskier option investments. That might permit them, as they saw it, to keep both themselves and their special clients happy. As evidence of their clients' ostensible municipal bond investments, their special clients, including Harrison, were given promissory notes signed first by Carpenter, but later also by Kenning. Those notes purportedly showed the high returns expected, in this instance by Harrison, with enticing annualized interest rates of approximately eighteen to sixty percent on short maturities.

Kenning pretended to be a big player in the bond market and to be making his income from their nonexistent municipal bond transactions. Harrison testified that he was given to understand that he could not receive the benefits of these special municipal bond deals offered by Kenning and Carpenter if he opened his own personal account with Dean Witter. He understood from Kenning that Dean Witter had a special program for their large brokers, which Kenning and Carpenter claimed to be, allowing these top Dean Witter producers to profit by buying certain municipal bonds on the bid side of the market. If the blocks of municipal bonds available under this special arrangement were bigger than Kenning and Carpenter could handle themselves, they explained to Harrison, then they would share these municipal bond investment opportunities with their special customers. According to Kenning and Carpenter, they were able to discount their usual commissions and to avoid the usual markup of Dean Witter, all for their own and their clients' benefit. Their special clients were instructed, however, that because of these special circumstances not available to Dean Witter's lesser producing brokers and their clients, they were to do business only with Kenning and Carpenter personally, not with Dean Witter directly.

Only a little of the income enjoyed by Kenning and Carpenter came from the commissions they occasionally generated for themselves on their own risky option investments or from their regular clients. Their Dean Witter trading account was in Carpenter's name only, but they considered it to belong to them both. There was evidence that the activity generated in their personal trading account was much higher than the industry average for employees of stock brokerage firms.

Carpenter appears to have spent most of his time looking after his and Kenning's personal option investments. Indeed, during his tenure at Dean Witter, Carpenter opened no more than five accounts for any of his other customers. Consequently Carpenter earned a minimum of commissions for almost three years, which the evidence suggested did not exceed $71,000. Yet Kenning and Carpenter paid into Dean Witter through their option investing in the trading account a little under two million dollars. Dean Witter allegedly profited from commissions on that activity in excess of $400,000.

Richard Frost, who had hired Kenning and Carpenter, was Dean Witter's Boca Raton branch manager with oversight responsibilities. He routinely received each month the statements of Carpenter's Dean Witter trading account. Dean Witter's rules required that these statements be reviewed by management. Carpenter's trading account statements revealed the unusually high amount of account activity, specifying the gains and losses. The account statements also showed Kenning and Carpenter often trading at the limit through that account. The energetic activity in the trading account, however, generated profits for Dean Witter. Dean Witter recognized those profits with letters of commendation to Kenning and Carpenter and even gave them a plaque in acknowledgement of their outstanding broker accomplishments. Periodically compliance officers of Dean Witter visited the branch office and among other accounts reviewed their trading account. Neither Kenning nor Carpenter, however, had any recollection of ever having been asked by a Dean Witter compliance officer about the very substantial losses they often sustained in their risky option investments, whether those losses could be handled by the two of them, and particularly where all the money was coming from for their trading account. If they were asked any pertinent questions, however, their answers appear to have been accepted without further investigation by Dean Witter.

Around the time Harrison got involved in the fraud, Carpenter had already paid Dean Witter about $800,000 to cover their net losses in the trading account. At one time Carpenter gave Dean Witter bad personal checks from his own personal bank account totalling over $100,000, supposedly to cover the substantial losses exceeding $300,000 in the Dean Witter trading account. Kenning and Carpenter had a good explanation to cover their NSF check problem, blaming it on the timing of their deposits, bad checks to them, and their withdrawals at the bank—a bookkeeping matter. Dean Witter then took steps, however, to protect itself from similar NSF checks. There was, nevertheless, Kenning explained, continual pressure from Frost to keep generating those profitable commissions for Dean Witter.

Harrison never opened an individual account at Dean Witter, nor did he ever receive a Dean Witter statement, nor did he have any correspondence with any Dean Witter personnel other than Kenning and Carpenter. Meanwhile Dean Witter had comprehensive and specific internal rules governing the business operations and the conduct of its employees. Frost and the compliance officers had the duty to enforce the rules. Those rules specifically prohibited employees from engaging, as here, in securities transactions outside the usual course of business of the firm. To prevent rule violations, for instance, incoming office mail was opened and any checks enclosed were taken out in the cashier's office. Harrison, however, sent his investment funds to Carpenter's home or to Carpenter's personal bank account. The promissory notes Harrison received from Kenning and Carpenter bore no reference to Dean Witter. When from time to time Harrison received some return on his supposed bond investments, it was by a personal check of Carpenter, or in cash given to him by Kenning or Carpenter and delivered somewhere other than in Dean Witter's office. Carpenter supplied Harrison with IRS Form 1099s which identified Carpenter, not Dean Witter, as the source of the income.[2] Harrison sometimes had contact with Kenning and Carpenter's secretaries at Dean Witter, who identified the called number as "Dean Witter." The evidence shows Harrison telephoned Kenning and Carpenter as many as forty to fifty times at their Dean Witter offices. On one occasion Harrison was shown the Dean Witter office.

Kenning testified that in their big activity days Carpenter did not even have a net worth. Carpenter was facing bankruptcy. Much of their clients' money and any profits Kenning and Carpenter occasionally managed to make for themselves all evaporated in their risky personal investments and expenses, including (in addition to their option investments) a horse farm, private start-up companies, other personal expenditures, and, of course, their Ponzi scheme repayments which kept their fraud on life support.[3] About forty percent of all cash Kenning and Carpenter received was being recirculated through their Ponzi scheme. Their investments, unfortunately, were all losers. There is no allegation by Harrison or anyone else that Dean Witter had actual knowledge of this scam. This

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[2] The income tax aspects of these transactions will be considered in more detail in the discussion of the third evidentiary issue raised by Dean Witter, *infra*.

[3] A "Ponzi" or "pyramid" scheme is one in which funds obtained from new investors are used to satisfy interest and principal obligations due on earlier investors' notes (and usually to line the pockets of the scheme's perpetrators). Such a scheme requires an ever-larger circle of new investors to keep it afloat, and thus almost invariably ends in disaster.

Kenning-Carpenter Ponzi scheme, however, lasted over thirty months in and around the branch office without being detected by Dean Witter.

Finally, and not surprisingly, this whole phantom securities operation collapsed around Kenning and Carpenter. They resigned from Dean Witter. It is not necessary to set forth here all the details of their fraudulent scheme which the jury heard, some of which could be deemed favorable to Dean Witter, and some not. The jury heard not only from Kenning, but also from Carpenter, Harrison, Frost, various personnel from Dean Witter, outside experts, and others. After weighing that evidence the jury resolved whatever evidentiary and credibility conflicts there may have been and found for Harrison under the jury instructions given by the trial court. Those instructions have not been made an issue in this appeal. We have reviewed the total trial transcript of this difficult trial. It was carefully handled by Judge Marovich as best the prior mandate of this court could be understood and applied.

The fraud as a factual matter is not disputed. Rather, the dispute is whether the evidence was sufficient to show Dean Witter liable under the Act, and whether the trial was fair as it relates to the exclusion of some of the tax evidence. Now it becomes our problem again.

## ANALYSIS

Our appellate standards of review are well recognized. In *Scaggs v. Consolidated Rail Corp.*, 6 F.3d 1290 (7th Cir. 1993), Judge Bauer explained the relevant standards:

> A motion to set aside the verdict is made pursuant to Federal Rule of Civil Procedure 50(b). We review a Rule 50(b) motion *de novo*, considering the evidence in the light most favorable to the prevailing party and drawing all reasonable inferences in favor of the prevailing party. If the evidence overwhelmingly favors the moving party, then the verdict cannot stand. [Citation omitted.] A motion for a new trial

> is made pursuant to Federal Rule of Civil Procedure 59(a). When reviewing a Rule 59(a) motion, we defer to the district court and reverse only if it has abused its discretion. In doing so, we determine whether the clear weight of the evidence is against the jury verdict, the damages are excessive, or for some other reason the trial was not fair to the moving party. [Citation omitted.]

6 F.3d at 1293.

### A. Control Person Liability

The judge based his instructions to the jury on the applicable sections of the Act and the Securities and Exchange Commission's Rule 10b-5.[4] The statute and rule,

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[4] SEC Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Section 20(a) of the 1934 Act establishes liability as follows:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t.

(Footnote continued on following page)

he explained, make it unlawful for anyone to commit a fraud in connection with the sale of a security. His instructions, in understandable language, gave the jury the law as we understand it to be and generally as expressed in our first opinion.

As we pointed out in *Harrison I*, 974 F.2d at 880, we have never used any test similar to the culpable participant test, as the district court had done in that case, "to so stingily limit the definition of control person." *Id.* That test originated with a 1978 case from the Ninth Circuit, and has since been repudiated.[5] The SEC's definition of control "counsel[s] broad remedial construction of the statute and recognition of a practical ability to direct the actions of those involved." *Id.* at 878. We have long recognized that some indirect means of discipline or influence, although short of actual direction, is sufficient to hold a "control person" liable. *Id.* at 880. We stated our view this way:

> We have looked to whether the alleged control-person actually participated in, that is, exercised control over, the operations of the person in general and, then, to whether the alleged control-person possessed the power or ability to control the specific transaction

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[4] *continued*

The definition of "control" promulgated by the Securities and Exchange Commission is:

> The term "control" (including the terms "controlling," "controlled by" and "under common control with") means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

17 C.F.R. § 240.12b-2 (1995).

[5] *See Christoffel v. E.F. Hutton & Co.*, 588 F.2d 665 (9th Cir. 1978), *overruled by Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990) (en banc), *cert. denied*, 499 U.S. 976 (1991).

> or activity upon which the primary violation was predicated, whether or not that power was exercised.

*Id.* at 881.

This interpretation does not make the broker-dealer an insurer of its registered representatives as Dean Witter claims. Section 20(a) of the Act, to the contrary, provides the alleged controlling person with an affirmative defense which, of course, that person has the burden of proving. Control person liability is foreclosed if the controlling person "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation." *Id.*

At trial, the district court instructed the jury among other things that Dean Witter could not be found liable merely because Kenning and Carpenter were its employees. The court explained that if control was found, Dean Witter could still escape liability if it established its good faith by showing it maintained a reasonable system of supervision, enforced that system with reasonable diligence, and that Dean Witter did not directly or indirectly induce the violations by Kenning and Carpenter. Because of this good faith defense and the scienter element required for the underlying 10b-5 fraud claims,[6] it was further explained that Dean Witter could not be liable in these circumstances for its mere negligence, but only if it acted recklessly. Recklessness was explained as conduct highly unreasonable, involving "not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, which presents a danger of fraud which is better known to the actor in this case, Dean Witter, or is so obvious that [Dean Witter] must have been aware of it." Applying those instructions and others, the jury found against Dean Witter.

Dean Witter's main contention on appeal regards the sufficiency of the evidence for the second element of the test for control liability, i.e., whether Dean Witter possessed the power or ability to control the specific predicate transaction, in view of its good faith defense. We first discuss the control issue, and explain our finding regarding the appropriate "specific predicate transaction" in part B, *infra.*

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[6] *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 209 n.28 (1976).

Dean Witter points to its comprehensive in-house rules, its compliance officers, the supervision exercised by its branch office manager, and the nature of the particular promissory note transactions as preventing or excusing control person liability. There is sufficient basis in the record, however, for a reasonable jury to conclude that even within a sophisticated, well-known, and reputable company such as Dean Witter, at least in this one instance, there was a total lack of sufficient diligence, that the supervision was only very casual or grossly indifferent, and that Dean Witter totally ignored the obvious warning signs. In view of the high monetary stakes and the risks resulting from sophisticated and contriving minds, mere reliance on published rules and indifferent or superficial supervision of Kenning and Carpenter's activities while providing income for Dean Witter could be viewed by a jury as reckless under the instructions.

There was also sufficient evidence for a reasonable jury to determine that had Dean Witter not shut its eyes to the various fraud signs available to it, as it did, then the whole scheme could have been detected and shut down by Dean Witter far earlier than when it collapsed. Furthermore, Dean Witter's explanations for a possible lack of diligence and its good faith efforts in enforcing its compliance systems was also before the jury. Dean Witter's Boca Raton branch manager, Richard Frost, testified that Dean Witter ran each branch office as an independent center. The profitability of the branch office, and the gross commissions from the registered agents in that branch, were factors in his own personal Dean Witter compensation. The more profitable the office, the greater was Frost's personal compensation. The ignored aggressive trading of Kenning and Carpenter in their trading account thus helped generate gross commissions benefiting Frost personally as well as Dean Witter. Frost testified he was aware that most of Kenning's commissions were generated in his and Carpenter's trading account, and not from commissions in their other customers' accounts. As Frost candidly said they were paying with "good money" so there was no reason for him to disbelieve Kenning and Carpenter. The problem was that though it was "good money" it belonged to somebody else and not to them.

This small portion from the deposition of Frost, here under cross-examination, serves as a sample to illustrate the total indifference of his management:

> Q. Did you discuss with John Carpenter where he was getting $98,000?
>
> A. No.
>
> Q. Did you discuss with John Carpenter where he was getting $25,000 to deposit in the account?
>
> A. No.
>
> Q. Did you discuss with John Carpenter how it came about that $50,000 check (sic) bounced in his account?
>
> A. Yes. It says someone wrote him a check. Wrote him a check bounced to him.
>
> Q. Did he tell you who bounced the $50,000 check to him?
>
> A. No.
>
> Q. Did you ask him what kind of business he was in or what relationship he had with someone who was bouncing a $50,000 check to him?
>
> A. I don't remember.
>
> Q. Did you become suspicious in April 1984 about any outside activities of John Carpenter?
>
> A. No.
>
> Q. Did you think it was ordinary and customary for an account executive to be passing or receiving $50,000 checks away from his employment?

A. Don't remember.

Q. Were there ever any other instances where you learned that checks in the tens of thousands of dollars were being bounced in John Carpenter's account?

A. I don't remember.

Dean Witter could be seen by the jury to have been influenced in its "look the other way supervision" by the commissions being generated by Kenning and Carpenter's risky options trading. In fact, as noted above, Dean Witter commended Kenning and Carpenter for their commission-generating activity, and at times even pressed for more of it. Just where all the money being invested by Kenning and Carpenter was coming from, whether it could possibly be within their own means, or whether the substantial losses Kenning and Carpenter were incurring could be covered by them, was not inquired about, or at most done so superficially without any investigation or follow-up. In any case this transparent or at least extremely suspicious situation surrounding Kenning and Carpenter's activities at Dean Witter was largely ignored.

The rather unusual combination of record setting activity in Kenning and Carpenter's own options account, sometimes to the limit and with substantial losses, while at the same time opening very few accounts for any other customers appears not to have been of significant concern to other Dean Witter personnel. Dean Witter's Deputy Director of Compliance agreed in his testimony that Carpenter's trading account showed aggressive trading. One of Dean Witter's internal rules includes a review of employees' accounts to be sure that type of trading is not excessive and conforms to the employees' financial circumstances. That compliance officer, however, could not recall that Carpenter, the most aggressive trader in that branch office, had ever been discussed. In fact the compliance officer knew little about Kenning and Carpenter. Another Dean Witter compliance officer testified that he had never seen option trading activity as great as that in Carpenter's account. These obvious warning signs, though noticed by Dean Witter compliance personnel, were totally ignored.

It was a violation of Dean Witter's rules for their registered representatives to use their individual Dean Witter personal accounts for their clients, as well as to do aggressive trading in their own accounts. Still, Kenning and Carpenter in effect ran their own fraudulent broker-dealer operation within Dean Witter for over thirty months without being detected. Considering all these facts and circumstances, a jury could reasonably have concluded under the instructions that more was required from a legitimate broker-dealer to protect itself from such employees and their possible fraudulent schemes. The amount of securities fraud litigation appearing in the courts, though fortunately the exception in the securities business, should be at least sufficient to encourage a continuous high standard of caution by broker-dealers to protect themselves and their clients from the machinations of their own unscrupulous employees. Dean Witter concedes the Kenning-Carpenter scheme eluded all their controls, but the jury believed it should not have, at least for the long period of time which it did.

Dean Witter further argues there is no way to control mail to an agent's home, or what its employees do in their own personal bank accounts away from Dean Witter, or what occurs when its employees meet a customer away from the office and transact their business in cash. That is true regarding isolated circumstances, but Dean Witter cannot totally ignore repeated warning signs that there were clandestine and irregular activities being conducted by its representatives within and around its organization.

Dean Witter also argues that Harrison's big investments show little correlation with the sums actually going into Kenning and Carpenter's options account. Not all of the money of the special investors went into that trading account; some of it went into the horse farm and elsewhere, but there is a sufficient correlation and relationship to strongly suggest that Kenning and Carpenter's excessive options speculations could not have been supported by their own limited means. It was obviously the money of others, in this instance Harrison's, that was being used and lost in the Dean Witter trading account. All these arguments of Dean Witter have some appeal, but are unavailing in the context of all the evidence considered by the jury.

Viewing the evidence in the light most favorable to the prevailing party, as we must, we cannot conclude that the evidence "overwhelmingly favors" Dean Witter in terms of control person liability, and thus conclude that Dean Witter was not entitled to prevail on its motion for judgment as a matter of law.

### B. Justifiable Reliance with Respect to the Underlying Primary Securities Fraud Section 10(b) Claim

Dean Witter also claims that it is entitled to a new trial because there was legally insufficient evidence to enable a jury to find the justifiable reliance necessary for a Section 10(b) violation. It also claims that the promissory notes themselves are properly regarded as the specific predicate transaction against which this reliance should be judged. As stated above, we review the district court's rulings under an abuse of discretion standard, and determine whether the clear weight of the evidence is against the jury verdict, jury instructions not being an issue.

As a preliminary matter, Dean Witter argues that our comment in *Harrison I* that no reasonable person could "naturally suppose that Kenning and Carpenter possessed the authority to use the employee account for Harrison's benefit," 974 F.2d at 884, is dispositive regarding the issue of reliance as an element of the predicate 10(b) violation under the Act. That prior comment was made only in the summary judgment context regarding the state law agency issue of *respondeat superior* liability, and not regarding the control provisions of the Act. Some of the same considerations may also apply in a *respondeat superior* state claim context, but reliance under the Act involves other considerations as well. We explicitly remanded the control issue back to the district court for the fact finder to determine the main statutory question of control person liability. That liability among other things requires a predicate securities violation. We also stated that:

> The alleged facts are sufficient to prevent our finding, as a matter of law, either that Dean Witter did not actually exercise control over the operations of Kenning and Carpenter in general or that Dean Witter did not possess the power or ability to control Kenning and Carpenter's transactions upon which the primary violation is predicated.

The issue of justifiable reliance under the Act in these particular circumstances was properly presented to and determined by the fact finder.

The trial court instructed the jury that to satisfy the justifiable reliance claim, Harrison must prove that he in fact relied upon false statements, and that he would not have engaged in the transactions in the absence of those statements. The jury was also instructed that Harrison must prove that this reliance was justified; that is, he could not have intentionally closed his eyes and refused to investigate circumstances in disregard of known or obvious risks. No objections were offered to these instructions, and we see none. The jury under these instructions found for Harrison.

We find sufficient evidence to support that verdict. Dean Witter asserts that the promissory notes Kenning and Carpenter gave to their special customers, unadorned with Dean Witter's name, could not serve as the basis for the required reliance. Dean Witter has focused its arguments on the promissory notes as if they were totally unrelated to the other parts of the fraud. Yet the promissory notes do not merely by themselves form the predicate securities violations here involved. Those notes can be viewed as little more than confirmations of the pretended municipal bond investments, or just lulling receipts for the money supposedly being invested for the victims in municipal bonds through the Dean Witter trading account. The notes, however classified, were nevertheless a part of Kenning and Carpenter's whole fraudulent scheme. That one fraudulent scheme cannot now be divided into its separate parts and then each part judged independently; neither would a victim of such a scheme reasonably believe he was investing only in personal promissory notes and not in municipal bonds with their tax benefits.

The security transactions at issue were the supposed purchase of municipal bonds through the Dean Witter trading account, not the promissory notes which ordinarily do not need to be acquired through a broker. The return Harrison was expecting to receive was from the municipal bonds, not the promissory notes. In Judge Marovich's opinion he concisely summed up the situation. He wrote: "Essentially, Kenning and Carpenter made the investment seem like a program that retained the relative safety and tax benefits of municipal bonds but offered a higher rate of return for the select group of individuals chosen by Kenning and Carpenter to receive this special benefit available only through them." The district judge further added that the evidence was "sufficient for a reasonable jury to find that Kenning and Carpenter, through persuasion, guile, deception and misdirection, lulled Harrison and over a hundred other investors into a false sense of security." Given this overall situation, the jury could have reasonably believed that the false representations involved in the total fraud scheme were relied on by Harrison as true. The causal connections between the aspects of this fraudulent scheme are enough to support a finding of reliance. *See Flamm v. Eberstadt*, 814 F.2d 1169, 1173 (7th Cir.), *cert. denied*, 484 U.S. 853 (1987).

The fact of reliance in this case, however, is not enough by itself; that reliance must be justifiable, or reasonable. *See Teamsters Local 282 Pension Trust Fund v. Angelos*, 762 F.2d 522, 530 (7th Cir. 1985). The jury was instructed as to this requirement, and found that it was met. Considering the fraud as a whole, we believe that here there was sufficient evidence to support that verdict. Kenning and Carpenter used their positions at Dean Witter, their trading account, and other indicia of their positions at the firm (such as office facilities, printouts from databases, and calling cards, etc.) to help operate their scheme. Kenning testified that he used his position at Dean Witter to make his victims feel comfortable about doing business with them. The jury was also instructed that the assumption of any known risk by Harrison, or any reckless risk-taking by Harrison, would necessarily negate a finding of reliance as that circumstance would be in the nature of an independent intervening cause. Dean Witter also offered its *in pari delicto* affirmative defense on which the jury was instructed, but that defense was rejected.

We do not believe the clear weight of all the evidence is sufficient to vacate the jury's verdict although there was evidence on both sides of the issue. The fact finder was properly instructed, and we will not disturb its verdict.

### C. The Exclusion of Income Tax-Related Evidence

Finally, Dean Witter argues that the district court erred in excluding certain tax form evidence that it contends would have supported its theory that no justifiable reliance existed. The evidence that was excluded and would have made the difference, according to Dean Witter, was the claim that Harrison knowingly accepted from Kenning and Carpenter incorrect IRS Form 1099s as well as dual sets of promissory notes. One set of these notes, it is alleged, stated the actual promised rate of return, but the other stated a lower rate of return to be used for income tax purposes.

Harrison disputed those facts alleged by Dean Witter. There were thirty-two promissory notes issued, whether characterized as confirmations or receipts or otherwise. As far as we can tell from the record, and as Harrison claims, only two of the thirty-two promissory notes were actually dual sets. On one dual set there was a difference in the supposed rate of return; one showed the rate at 7½% and the other at 9¼%, less than a 2% difference.

One of the notes in the other dual set indicated on its face that it was merely a duplicate.

The IRS Form 1099 is a yearly form designed to show income to a taxpayer from an identified source; it is to be used for the recipient's income tax purposes. Dean Witter points out that the Form 1099 received by Harrison for 1985 showed less than what Harrison actually received in 1985 from Kenning and Carpenter. This was done, Dean Witter says, at Harrison's direction. Dean Witter labels the payments from Carpenter to Harrison as cash interest payments to be included in his return.

The district court allowed the Form 1099 into evidence which showed that Carpenter, not Dean Witter, was the payor. Harrison used that form to report his interest income for 1985. Dean Witter was then allowed to show and argue those facts pointing out that Dean Witter was not involved with any of the reported income or the Form 1099. The district court did not allow Dean Witter, however, to attempt to show that Harrison should actually have reported more income, or that Harrison knew he should have reported more income. That he allegedly did not correctly report his income to this extent, Dean Witter argues, shows that Harrison himself was culpable, and this inference might have led the jury to conclude otherwise on the issue of reliance.

In fact it cannot be certain that any interest income was paid to Harrison even if Harrison may have thought he was earning interest from the promissory notes. In his deposition, Kenning testified as he saw it how some of the investors fared. Kenning and Carpenter would at times pay, when they had to, what they called "interest" to an investor who had already but unknowingly lost the principal of his investment. In classic Ponzi-scheme fashion, when an investor wanted a return on his investment, that particular impatient investor would be paid "interest" out of the money paid in by other investors. There was also a variation. As it was explained by Carpenter, sometimes those "interest" payments were often no more than "the investors' own money going back in. In other words, they would send us a check a week before our monies were due and we'd be—let the accountant send it back out to them."

In this situation, the district judge rightly declined to begin a tax evasion trial within the midst of the securities fraud case. The difficulty of that tax exploration would be compounded by the particular facts of this fraud. It could be that there was no taxable interest paid, only Ponzi payments to keep things from exploding. Perhaps some of it was interest. On the other hand, there could also be the question of what Harrison may have considered the payments to be, i.e., his own intent. The district court understandably concluded that if there was some activity that might amount to tax cheating, the IRS would have to figure that out, not the jury in this securities case.

Dean Witter sought to open up these tax matters before the jury for the purpose of showing that Harrison's knowledge precluded a finding of justifiable reliance. That effort, in these factual circumstances, would not only have prolonged the trial and confused the jury and possibly everybody else involved as well, but could not have added justifiable reliance evidence to the extent Dean Witter claims. The issue would have been further complicated by the fact that Harrison thought he was investing in municipal bonds which would provide tax-free income. Any theoretical interest income which was underreported by Harrison due to the fraud of Kenning and Carpenter would have been of dubious value to Dean Witter in view of the other evidence introduced separating Dean Witter from the notes and the Form 1099s.

We believe the trial judge was justified in concluding under Fed. R. Evid. 403 that this tax evidence was excludable even if relevant, on the ground that its probative value was substantially outweighed by prejudice to Harrison, confusion of the jury, and a waste of time. This, in effect, is what he did. The possible tax issue is sufficiently separate from the investment fraud so as not to be unnecessarily entangled in the same trial. Moreover, there was the other evidence of Harrison's possible complicity or awareness which might have supported a finding of a *lack* of justifiable reliance. The questionable things concerning Harrison's own conduct as would have possibly impacted on jury issues were not excluded. The 1099 tax form issue was presented to the jury by Dean Witter to show that the money Harrison received came from Carpenter, not Dean Witter. Before the jury, Dean Witter also questioned why Harrison's tax returns reported a substantial sum as interest received when municipal bond interest is not taxable. In the same final argument, however, it was candidly conceded by Dean Witter that Frost, its branch manager, was "not perfect." In sum, we do not agree that the additional uncertain tax evidence could have sufficiently helped Dean Witter prevail before the jury on the issues arising under the Act. Thus we do not believe that in these difficult circumstances the trial judge can be faulted for the way in which he exercised his evidentiary discretion. The verdict of the jury sorting out the evidence under the instructions must stand.

## *CONCLUSION*

The case is therefore AFFIRMED in all respects.

A true Copy:
Teste:

*Clerk of the United States Court of Appeals for the Seventh Circuit*

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

## JUDGMENT — WITH ORAL ARGUMENT

Date: March 20, 1996

BEFORE:

Honorable HARLINGTON WOOD, JR., Circuit Judge
Honorable MICHAEL S. KANNE, Circuit Judge
Honorable ALLEN SHARP, Chief District Judge*

No. 95-1970

HUDSON T. HARRISON and HARRISON CONSTRUCTION, INCORPORATED, an Illinois corporation,

Plaintiffs-Appellees,

v.

DEAN WITTER REYNOLDS, INCORPORATED,

Defendant-Appellant.

Appeal from the United States District Court
for the Northern District of Illinois, Eastern Division
No. 86 C 8003—George M. Marovich, Judge

The judgment of the District Court is AFFIRMED, with costs, in accordance with the decision of this court entered on this date.

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* The Honorable Allen Sharp, Chief Judge of the Northern District of Indiana, sitting by designation.

[Dated March 20, 1995]

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

HUDSON T. HARRISON, and )
HARRISON CONSTRUCTION, INC., )
an Illinois corporation, )
)
Plaintiffs, )
v. ) 86 C 8003
)
) Judge
DEAN WITTER REYNOLDS, INC., ) George M. Marovich
a Delaware corporation, )
)
Defendants. )

## MEMORANDUM OPINION AND ORDER

This case has slowly made its way through a few judges, several opinions and a trip to the Seventh Circuit in a highly contentious battle that grew out of the aftermath of a massive fraudulent scheme engineered by two employees of Defendant Dean Witter Reynolds, Inc. ("Dean Witter"). The case went to trial before this Court on the one surviving theory of liability advanced by Plaintiffs, control person liability under § 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t(a). On September 16, 1994, the jury returned a verdict in favor of Plaintiffs in the amount of $3,424,663.59. Dean Witter filed a motion for judgment as a matter of law, or alternatively, for a new trial pursuant to Fed. R. Civ. P. 50(b) and 59(a).[1] Plaintiffs Hudson T. Harrison and Harrison Construction, Inc. (collectively, "Harrison") have filed a motion to alter or amend the judgment under Rule 59(e) to include prejudgment interest. This opinion considers first the motions filed by Dean Witter and then the motion filed by Harrison. For the reasons set forth below, the Court denies Dean Witter's motions and grants Plaintiffs' motion.

### *Dean Witter's Motion for Judgment as a Matter of Law*

Under Rule 50, to obtain judgment as a matter of law, Dean Witter must show that "there is no legally sufficient evidentiary basis for a reasonable jury to find for [Harrison]." Dean Witter advances two principal arguments in support of its motion. First, Dean Witter argues that Harrison failed to establish a predicate violation of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), Rule 10b-5 of the Securities Exchange Commission. Specifically, Dean Witter argues that Harrison failed to show justifiable reliance upon the representations of Kenning and Carpenter. Second, Dean Witter argues that Harrison failed to establish the second prong of the test for control person liability under § 20(a) because Harrison failed to prove that Dean Witter had the ability or power to control the specific activities of Carpenter and Kenning that constituted the alleged § 10(b) violations committed by Carpenter and Kenning.

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[1] Although it is this Court's usual practice to rule on such motions promptly, the briefing of these motions was not completed until November 23, 1994. At that time and for a substantial period thereafter, the Court's schedule did not permit consideration of these motions.

Before the Court can consider the merits of these arguments, we first must address Harrison's contention that Dean Witter waived its right to bring the motion because it failed to renew the motion at the close of all the evidence in this case. In *Benson v. Allphin*, 786 F.2d 268 (7th Cir. 1986), *cert. denied*, 479 U.S. 848 (1986), the court commented that "this circuit has allowed something less than a formal motion for directed verdict to preserve a party's right to move for judgment notwithstanding the verdict." The Seventh Circuit has also explained that "[d]ue to Seventh Amendment concerns, a motion for j.n.o.v. ordinarily cannot be made unless it was preceded by a motion for a directed verdict made at the close of all the evidence." *Pro Football Weekly, Inc. v. Gannett Co., Inc.*, 988 F.2d 723, 726 (7th Cir. 1993) (citing *Benson*, 786 F.2d at 273). It is clear that Dean Witter did not formally renew its motion for judgment as a matter of law at the close of the all the evidence. Only Plaintiffs made such a formal motion. The question then is did Dean Witter sufficiently renew the motion in some form.

Dean Witter argues that the following commentary from counsel at the close of the evidence indicates Dean Witter renewed its motion:[2]

> I'm saying [the options trading is] not the activity they had to show we have the power or ability to control. They had to make the jump from this activity, our control over this activity, which is part of our general control, gives us the power or ability to con-

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[2] The Court chooses to quote the passage in full. Dean Witter substantially excerpted the passage.

> trol the specific activity, which is the activity that violated the laws and the conduct on which they're basing their claim.
>
> Otherwise we're getting sued by Carpenter, not by Harrison. We're talking about the account. So for that reason I say *they have not established that control as a matter of law.*

Dean Witter points to the emphasized portion as supporting the claim that they sufficiently renewed their motion. In doing so, Dean Witter has ignored the context in which counsel made this statement. This commentary comes in response to Harrison's motion for judgment as a matter of law. When viewed in its complete context it is clear to the Court that counsel was arguing that Harrison had failed to meet the burden of showing an entitlement to judgment as a matter of law on the issue of control and not that Dean Witter was entitled to such a judgment. Under the circumstances, the Court does not find that Dean Witter sufficiently renewed its motion for judgment as a matter of law at the close of all the evidence. Accordingly, this Court cannot consider the current motion for judgment as a matter of law. *Benson*, 786 F.2d at 273.

Even were we to find that the motion was renewed by Dean Witter, the Court could not consider Dean Witter's arguments regarding justifiable reliance. We do not find that Dean Witter raised this argument in its initial oral motion by a limited reference to the phrase "proximate cause." Dean Witter certainly did not argue the issue in responding to Plaintiffs' motion at the close of the evidence. As for Dean Witter's suggestion that the Court forced counsel to proceed with an oral motion when counsel wished to wait until the following morning to present a formal motion, we do not find this adequately explains counsel's failure to raise long disputed points in a case that has been proceeding since 1986. Significantly, the record contains no indication that counsel for Dean Witter ever tendered such a formal motion even if only to make a record. Indeed, Dean Witter could have tendered, but did not tender, a written motion two days later at the close of the case as a formal renewal of their prior oral motion. Finally, while the Court acknowledges some uncertainty in the record regarding the impact of the Seventh Circuit's ruling on the issue of the required predicate violation of § 10(b), the Court finds the Seventh Circuit's directive regarding § 20(a) exceedingly clear. The Seventh Circuit stated:

> The alleged facts are sufficient to prevent our finding, as a matter of law, either that Dean Witter did not actually exercise control over the operations of Kenning and Carpenter in general or that Dean Witter did not possess the power or ability to control Kenning and Carpenter's transactions upon which the primary violation is predicated. Accordingly, it was error to grant Dean Witter's motion for summary judgment on the basis that Dean Witter was not a controlling person. We leave that determination to the factfinder.

*Harrison v. Dean Witter Reynolds, Inc.*, 974 F.2d 873, 881 (7th Cir. 1992), *cert. denied*, 113 S. Ct. 2994 (1993).

In considering the statutory affirmative defense of good faith, the Seventh Circuit again spoke plainly:

> The alleged facts indicate Dean Witter had rules in place to prevent various types of fraud. For example, in addition to those noted above, the rules also required that supervisors ensure an employee's investments were commensurate with his or her resources.

> Indeed, on more than one occasion the head of Dean Witter's compliance department asked the local branch manager to investigate the heavy volume in Carpenter's account. He did ask Carpenter and Kenning about it, but apparently accepted without further investigation Carpenter's explanation that it was his own money. As it turned out, the two lost some $600,000 in roughly their first year at Dean Witter and some $2,000,000 over the ensuing two years without attracting, what they might consider, unwarranted attention. Under the alleged facts of the present case we cannot say, as a matter of law, that Dean Witter acted in good faith and neither directly nor indirectly induced the act or acts constituting the violation. This determination, too, must be left to the factfinder.

*Id.* at 881-82. This Court was bound to follow the holding of the Seventh Circuit that clearly stated matters remained for the factfinder. The presentation of the evidence at the trial of this case did not introduce facts materially different from the disputed facts before the Seventh Circuit. Material disputes of fact precluded summary judgment and, in this Court's view, the same or similar disputes preclude judgment as a matter of law. Accordingly, there was and is no basis nor authority for this Court to deviate from the express direction of that opinion in ruling on any of the motions for judgment as a matter of law whether properly renewed or not. Dean Witter's motion for judgment as a matter of law is denied.

### *Dean Witter's Motion for a New Trial*

The Court next considers Dean Witter's motion for a new trial brought pursuant to Fed. R. Civ. P. 59(a). A motion for new trial may be granted where "the clear weight of the evidence is against the jury verdict, the damages are excessive, or for some other reason the trial was not fair to the moving party." *Scaggs v. Consolidated Rail Corp.*, 6 F.3d 1290, 1293 (7th Cir. 1993); *Forrester v. White*, 846 F.2d 29, 31 (7th Cir. 1988). Dean Witter appears to attack both the weight of the evidence and several rulings made by this Court in support of its motion. We will take each area of dispute in turn.

Dean Witter first argues that Harrison failed to prove justifiable reliance on the various misrepresentations of Kenning and Carpenter. We start with the observation that the jury *could* have found for Dean Witter on the evidence presented. That observation, however, does not compel the conclusion that the jury's decision in favor of Harrison was contrary to the weight of the evidence.

Having reviewed the transcripts of this trial, we do not find that the evidence weighs so heavily against a finding of justifiable reliance that a new trial is warranted. Kenning, Carpenter and Harrison explained in detail the nature of the investments presented to Harrison. The testimony indicates that Kenning explained the high rate of return resulted from his access as a Dean Witter vice-president to a limited municipal bond investment vehicle which reduced or eliminated the traditional mark-ups and commissions. Essentially, Kenning and Carpenter made the investment seem like a program that retained the relative safety and tax-benefits of municipal bonds but offered a higher rate of return for the select group of individuals chosen by Kenning and Carpenter to receive this special benefit available only through them. In the end, the evidence was close but sufficient for a reasonable jury to find that Kenning and Carpenter, through persuasion, guile, deception and misdirection, lulled Harrison and over a hundred other investors into a false sense of security.

To be sure, the jury had before it significant evidence that could have resulted in a finding that Harrison did not justifiably rely on the representations of Kenning and Carpenter. Harrison primarily handled the transactions through Carpenter's home and his personal bank account, funds were transferred to Carpenter personally, payments were made by cashier's check, personal check or in cash and not through a Dean Witter check. Harrison did not receive documents or statements from Dean Witter, instead he received promissory notes signed by Carpenter and later Kenning. The notes reflected a rate of return in excess of what one might expect for typical municipal bond transactions. Harrison would not have to pay the standard mark-ups and commissions by going through Kenning and Carpenter. Despite the purported tax free status of the interest to be earned on these municipal bonds, Harrison reported interest income on his tax returns. He also received tax documents (Form 1099) from Carpenter personally not from Dean Witter.

Having reviewed the evidence, the Court still finds the jury's decision permissible though certainly not inevitable. Next, we turn to a major focus of Dean Witter's motion. Dean Witter argues that the Court excluded or prevented it from presenting to the jury certain crucial pieces of evidence that would show Harrison's lack of justifiable reliance.

It is important in addressing Dean Witter's contentions to review briefly the Court's rulings on two of Plaintiffs' motions in limine. This Court ruled that Dean Witter would not be permitted to introduce evidence that Harrison had received two sets of promissory notes from Carpenter and Kenning, one purportedly indicating an actual rate of return and one indicating a lower rate of return. The Court's commentary clearly indicated its concern with introducing a highly prejudicial side issue into this case, namely the issue of whether Harrison intended to and did avoid paying taxes through use of the two sets of documents. The Court found the issue more properly left for the Internal Revenue Service to resolve rather than the jury. As argued in its brief in opposition and its oral argument to the Court, Dean Witter intended to use this evidence as part of its effort to show that Harrison himself bears equal or greater responsibility for his loss and interfered with Dean Witter's ability to monitor and supervise Kenning and Carpenter. In other words, Dean Witter focused on the relevance of such evidence to the § 20(a) control person claim and their affirmative defenses to that claim. Dean Witter did not argue the relevance of such evidence to a showing of a lack of justifiable reliance.

In ruling on the motions, the Court indicated (1) that Dean Witter could argue and introduce evidence about the avoidance of traditional commissions under the Kenning/Carpenter investments and (2) that Dean Witter could argue and introduce evidence showing how Harrison treated the income he received on his tax forms and who he listed as the source of the income, namely Carpenter. The evidence and argument excluded related to whether or not Harrison avoided taxes and sought to avoid taxes lawfully due on the amounts he received from Carpenter and Kenning.

It is true that Harrison commented on his desire to pay his share of the taxes on the gain on the bonds. Dean

Witter argues that this testimony increased the prejudice of the Court's ruling. Counsel for Dean Witter could have argued that this testimony opened the door to at least some exploration of the depth of Harrison's commitment to pay his share of taxes. They did not and we do not find the absence of this evidence rendered the trial unfair, especially given the substantial evidence before the jury which could have supported a finding of a lack of justifiable reliance.

Now as to the Court's rulings regarding the testimony of Lawrence Kaplan, an accountant, Dean Witter maintains that the Court erred when it refused to allow Kaplan to testify about what the Plaintiffs' records and tax returns reflected about their understanding of the nature of the transactions with Carpenter and Kenning. What the Court ruled is that Kaplan could not express opinions on what Mr. Harrison could or could not have believed based on the accountant's review of the records. The Court found such a decision best left to the jury.

The Court indicated that it would permit Kaplan to testify that Harrison records indicate that Mr. Harrison "booked" the transactions as loans to Carpenter and Kenning, and that he recorded the interest as ordinary interest received from Carpenter, not from Dean Witter. As the Court stated, "as far as the final conclusion as to what this means in Mr. Harrison's mind, I will leave that to the province of the jury." Later the Court indicated that Kaplan could not express the following opinion offered by Dean Witter as potential testimony: "In my opinion, based on the financial records and data I reviewed, Mr. Harrison was dealing with two individuals as opposed to dealing with Dean Witter."

In the Court's view and with due regard for Fed. R. Evid. 702, Kaplan's expertise as an accountant allows him to describe the nature and objective meaning of the financial data he reviewed to assist the jury in evaluating that evidence; it does not, however, allow him to speculate as to what that data means in the mind of another person who is not an accountant. As this Court attempted to make clear to counsel, Kaplan could testify to "whatever [Harrison] did" from an accountant's perspective. Beyond this, the proposed conclusions would not aid the jury in their effort to evaluate what Harrison's actions indicated about his understanding of the transactions, his reliance on Carpenter and Kenning, and whether his conduct interfered with Dean Witter's ability to supervise and control Carpenter and Kenning. We do not believe the rather narrow ruling substantially or unfairly prejudiced Dean Witter in the presentation of its case.[3]

Having considered Dean Witter's arguments regarding justifiable reliance, we now proceed to consider Dean Witter's contentions regarding control person liability under § 20(a). Dean Witter consistently chastises Plaintiffs, opposing counsel and, to a certain extent, the Court for a failure to correctly identify and apply the second prong of the test for control person liability as stated by the Seventh Circuit. More specifically, Dean Witter complains of Harrison's failure to offer any evidence that Dean Witter had the power or ability to control the Plaintiffs' personal transactions with Carpenter and Kenning. Dean Witter also refers extensively to Plaintiffs' sleight of hand and bait and switch argument regarding promissory notes and municipal bonds. Setting aside the hyperbole, the Court will now address Dean Witter's arguments.

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[3] The Court notes that with the exception of the preclusion of the two noted opinions, the Court allowed the rest of the proposed testimony. Dean Witter made no further record of questions or answers it wished to ask of Kaplan.

Initially, the Court feels it must correct a misstatement or perhaps misapprehension on the part of Defendant. Defendant states that this Court "failed to appreciate until the jury instruction conference that the relevant Section 10(b) issues had not been decided in earlier proceedings . . . ." Based on this Court's review of the Seventh Circuit's opinion and Judge Duff's opinion, this Court did initially consider the trial to be focused on the two major issues requiring a trial as identified by the Seventh Circuit in *Harrison*. The Seventh Circuit was silent on the issue of § 10(b) and Dean Witter admits it was neither argued nor briefed before that court.

Judge Duff, however, was not silent on the issue. In reaching his decision in favor of Dean Witter, he did not find that there were genuine issues of material fact on the issue of the predicate securities violation committed by Carpenter and Kenning. Instead, prior to considering Dean Witter's liability under § 20(a), Judge Duff made the following statement: "Having *established* that Kenning and Carpenter committed fraud in connection with their sales of these notes, he now must show that Dean Witter exercised control over the two brokers with respect to these sales." *Harrison*, 715 F. Supp. 1425, 1437 (N.D. Ill. 1989). The latter half of this statement contributed to the Seventh Circuit's reversal of the summary judgment because the court found Judge Duff had employed the improper "culpable participant" test.

While this Court found it curious that Judge Duff had made no mention of reliance, actual or justifiable, it appeared that he necessarily would have considered this issue to conclude that Harrison had "established" fraud in connection with the sale of the promissory notes. As this Court initially indicated to counsel, it seemed that Judge Duff had decided the issue adversely and the matter of § 10(b) violations was the law of the case.

This Court has previously considered the Seventh Circuit's position on the law of the case doctrine in a similar setting. *See Heller Int'l Corp. v. Sharp*, 839 F. Supp. 1297, 1307 (N.D. Ill. 1993). The Seventh Circuit stated the basic premise as follows: "If a final judgment had been entered, the case appealed, the judgment reversed, and the case remanded, the trial judge would be required to adhere on remand to the rulings that he had made before the case was first appealed, provided of course that they had not been set aside by the appellate court. "*Williams v. Commissioner*, 1 F.3d 502, 503 (7th Cir. 1993); *see also Williamsburg Wax Museum, Inc. v. Historic Figures, Inc.*, 810 F.2d 243, 250 (D.C. Cir. 1987). As noted in *Heller* and equally applicable here, the *Williams* court also considered the impact of a subsequent change of judges on the law of the case. The court noted:

> [l]itigants have a right to expect that a change in judges will not mean going back to square one. The second [in this case, the fourth] judge may alter previous rulings if new information convinces him that they are incorrect, but he is not free to do so even though the time for reconsideration has not expired, merely because he has a different view of the law of the facts from the first judge. In this situation, the doctrine of the law of the case has bite.

*Williams*, 1 F.3d at 503 (citations omitted). Acknowledging that the doctrine is a "rule of practice," the difficulty for this Court was determining whether the Seventh Circuit's reversal of the summary judgment on the § 20(a) claim necessarily set aside any conclusions made by Judge Duff or any concessions made by Dean Witter on the predicate § 10(b) violation.[4] Neither counsel were able to provide much assistance to the Court on an important issue that could have been raised and decided long before the trial of this case.

Eventually, however, the Court departed from its initial view for several reasons. First, Judge Duff did not discuss reliance in his opinion as it pertains to § 10(b) claims. Second, because Dean Witter had moved for summary judgment and not Harrison, Judge Duff need not have finally concluded that Harrison had proved his § 10(b) claim as a matter of law to dispose of the motion before him. Perhaps because the question was not argued, neither Judge Duff nor the Seventh Circuit discussed the application of their emphatic holdings on agency and respondeat superior to the issue of justifiable reliance. In addition, the Court was not convinced that the criminal proceedings against Carpenter and Kenning had fully disposed of justifiable reliance as an issue in this case. Finally, the Seventh Circuit reversed and remanded the summary judgment on the § 20(a) claim, a claim that has as a necessary predicate a securities violation by the alleged controlled person.

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[4] This Court was and remains concerned with the following commentary from the Seventh Circuit regarding Harrison's respondeat superior arguments. The Seventh Circuit emphatically stated:

> We cannot nor can any reasonably prudent person naturally suppose that Kenning and Carpenter possessed the authority to use the employee account for Harrison's benefit. It simply is not believable that their authority would extend so far. Furthermore, Harrison's transactions with Kenning and Carpenter were not regular and could not appear to be within the ordinary course of business, within the ordinary course of their business, at Dean Witter.

*Harrison*, 974 F.2d at 884. Such a finding presents a powerful argument that *Harrison* could not show justifiable reliance and perhaps the Seventh Circuit could have affirmed the summary judgment on this basis. It did not do so, however, so this Court was left to follow the mandate and the opinion which plainly directed this Court to present the § 20(a) claim to the fact-finder. As this Court often has remarked, "Ours is a hierarchical judiciary, and judges of inferior courts must carry out decisions [of the appellate courts]." *Gacy v. Welborn*, 994 F.2d 305, 310 (7th Cir.), *cert. denied*, 114 S. Ct. 269 (1993).

Because no ruling was requested, this Court had made no ruling on the issue prior to trial. While Dean Witter did press opposing counsel to identify more precisely Plaintiffs' theory of the case, we do not believe Dean Witter adequately presented the matter to the Court for decision in the early portions of this case. We also do not believe the absence of a definitive ruling on the issue altered Plaintiffs' presentation of their evidence. As discussed above, substantial testimony presented by Plaintiffs and elicited by Dean Witter in cross-examination concerned the issue of reliance. As to whether the absence of a earlier definitive ruling prejudiced Dean Witter in presenting its case, the Court does not agree that it did. In addition to those matters already addressed, let us explain further by analyzing Dean Witter's claim that Plaintiffs mislead the Court and the jury.

The "bait and switch" Dean Witter refers to involves Dean Witter's perception that Harrison relies on promissory notes to establish a § 10(b) violation but then relies on the municipal bond/options scheme as the activity which Dean Witter had the power or ability to control for purposes of the second prong of the control test under § 20(a). Dean Witter maintains that Harrison failed to show that Dean Witter had the power or ability to control Plaintiffs' personal transactions with Carpenter memorialized in the promissory notes. Dean Witter argues that Harrison improperly argued that Dean Witter had the power and ability to control the options trading activity in Carpenter's account. According to Dean Witter, this focus mislead the jury and resulted in an improper application of the second prong of the test for control enunciated by the Seventh Circuit.

At the core of Dean Witter's argument is what the Court perceives as an unwarranted and artificial separation of the activities of Carpenter and Kenning occurring unbeknownst to Dean Witter and the activities of Carpenter and Kenning in trading heavily in options in Carpenter's employee account. Dean Witter correctly notes that the second prong of the control test asks "whether the alleged control-person possessed the power or ability to control the specific transaction or activity upon which the primary violation was predicated, whether or not that power was exercised." *Harrison*, 974 F.2d at 873. Where Dean Witter falters is perhaps due to a failure to recall a comment preceding this statement of the control test. Having reviewed the development of the law of control-person liability, the Seventh Circuit set forth this observation which this Court takes as its guide: "We have long viewed the statute as remedial, to be construed liberally, and requiring only some *indirect* means of discipline or influence short of actual direction to hold a control person liable." *Id.* at 880 (emphasis added) (internal quotations omitted).

Dean Witter notes, not without justification, Plaintiffs previously recognized facility for shifting the posture and focus of their arguments in this case. On the issue of control, however, the Court finds Dean Witter's focus too narrow. Dean Witter has essentially argued that Plaintiffs must show that Dean Witter had the power or ability to control all the activities regarding the promissory notes, the transactions Dean Witter asserts are the source of any potential securities law violation by Carpenter and Kenning. While the control test does focus on the power or ability to control the specific transaction or activity upon which the primary violation was predicated, the jury was entitled, based on the evidence, to consider the activity in Carpenter's employee account as part and parcel of the fraudulent scheme. More importantly, the jury was entitled to consider whether Dean Witter's power or ability to control and monitor the use of Carpenter's employee account, directly or indirectly, gave Dean Witter the power or ability to control the promissory note activities occurring largely outside of Dean Witter's offices.

Anticipating this problem, Dean Witter engages in a lengthy speculation about what Carpenter could or would have done had Dean Witter asked for additional information about the source of his funds, stopped his trading in options, or fired him. While much of their argument is plausible, if not entirely supported by the record in this case, it remains an argument that Dean Witter made to the jury unsuccessfully. But in counsel's own words in closing on behalf of Dean Witter, the whole scheme could have and likely would have "blow[n] up instantly" if people contacted Dean Witter. Thus, to take one example from Dean Witter's litany, what happens if Dean Witter fires Carpenter and perhaps Kenning for refusing to divulge the source of the funds used to trade options in Carpenter's account? Based on the evidence, the jury could reasonably conclude that Carpenter and Kenning might have ceased their activity because the instrument upon which they built their story and through which they hoped to dig themselves out of financial trouble would have disappeared. It would have been exceedingly difficult for Carpenter and Kenning to casually assure investors that all was well when a phone call to Dean Witter's offices discloses that neither of the successful duo of Kenning and Carpenter are employed with the firm.

We need go no further because we now are straying from the core of the test which is concerned with power or ability to control, not with whether that power was exercised nor the probable consequences or ultimate success of the use of the power to control the specific violative transactions and activities. The question of what could the control person have done under the circumstances is more properly considered in evaluating the statutory good faith affirmative defense. *See Donohoe v. Consolidated Operating & Production Corp.*, 30 F.3d 907, 912 (7th Cir. 1994). The issue of affirmative defenses brings us to Dean Witter's argument about the Court's refusal to instruct the jury on two purported affirmative defenses.

Let us start with the supposed affirmative defense of dual agency, a defense not mentioned nor even alluded to by the Seventh Circuit in *Harrison* despite its extensive review of its prior holdings on § 20(a). Having reviewed the authorities relied upon by Dean Witter, the Court finds the argument wholly unsupported and indeed nearly a misrepresentation of the holding of the cited cases, *Henricksen v. Henricksen*, 486 F. Supp. 622, 680 (E.D. Wis. 1980), *aff'd in part, rev'd in part*, 640 F.2d 880 (7th Cir. 1981). In the district court opinion which Dean Witter cites as support for the use of a dual agency defense, Judge Gordon did discuss the problems of assessing liability when a person is the agent of more than one party. Judge Gordon's rulings on this issue, however, were clearly and carefully directed toward the liability of a brokerage firm, Smith Barney, under principles of agency law and the doctrine of respondeat superior. As indicated in the opinion, "[a]pplication of these general [common law] principles does not dispose of Smith Barney's potential liability under the federal securities laws." *Henricksen*, 486 F. Supp. at 633. The same careful delineation of the subtle distinctions between respondeat superior liability and § 20(a) liability are fully present in the Seventh Circuit's prior opinion in this case. We find no support in the tendered authorities for Dean Witter's so-called dual agency affirmative defense.

Dean Witter next argues that this Court erred in refusing to instruct the jury on the proposed affirmative defense that Carpenter was acting outside Dean Witter's statutory control. Dean Witter maintains that this defense is supported by the Seventh Circuit's prior opinion in this case, as well as two Ninth Circuit cases, *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1575-76 n.26 (9th Cir. 1990) (en banc), *cert. denied*, 499 U.S. 976 (1991); *Hauser v. Farrell*, 14 F.3d 1338, 1341 (9th Cir.

1994). The Seventh Circuit did note the *Hollinger* court's footnote[5] in its review of the cases interpreting § 20(a), but it did not indicate its support of this statement as an affirmative defense. The *Harrison* court did not discuss the proposition at all in evaluating whether summary judgment in favor of Dean Witter was proper.

Subsequent to the Seventh Circuit's decision in this case, the Ninth Circuit had occasion to explore what conduct by a broker is outside the broker-dealer's statutory control. In *Hauser*, the court considered whether a broker-dealer could avoid § 20(a) liability where two brokers solicited and sold investments in a partnership to plaintiffs. The undisputed evidence indicated that the investors and brokers understood that the partnership was a private business venture of the brokers and had no connection to the broker-dealer or any investment products offered by the broker-dealer. The uncontroverted evidence in *Hauser* showed that plaintiffs did not place money with the brokers for investments in markets to which the brokers had access "only by reason of their relationship with [the brokerage firm]" *Hauser*, 14 F.3d at 1343. While the precise nature of this "outside of statutory control" contention remains uncertain even after *Hauser*, we do not find the absence of an instruction unduly prejudicial in this case.

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[5] The *Hollinger* court noted the possibility of actions by a broker outside the firm's control:

> The broker-dealer may also, of course, rely on a contention that the representative was acting outside of the broker-dealer's statutory "control." For example, [the broker-dealer] could argue that when [plaintiffs] entrusted their money to [the broker] they were not reasonably relying upon him as a registered representative of [the broker-dealer], but were placing the money with [the broker] for purposes other than investment in markets to which [the broker] had access only by reason of his relationship with [the broker-dealer].

*Hollinger*, 914 F.2d at 1575-76 n.26.

The Court views the underlying argument (which Dean Witter did make to the jury) adequately encompassed by the instructions the jury did receive and which, if the argument were accepted by the jury, could have compelled a decision in Dean Witter's favor. The jury was instructed on Plaintiffs' need to prove justifiable reliance and Dean Witter's argument regarding the personal nature of these transactions and the structure of the transactions goes directly to this issue. The jury also was instructed on the two prongs of § 20(a) liability. In line with this instruction, Dean Witter argued strenuously about its inability to control Carpenter's private dealings with Harrison. Additionally, the Court instructed the jury on the statutory good faith defense which allows Dean Witter to escape liability if the jury found its system of supervision was reasonably enforced and that Dean Witter did not directly or indirectly induce the securities violations of Carpenter and Kenning. Finally, the Court instructed the jury to consider whether Plaintiffs' own conduct should preclude any recovery. Clearly, Dean Witter's argument that Carpenter acted outside of its control and that Plaintiffs knew he was doing so was properly before the jury under any of these instructions. The absence of the tendered instruction did not preclude Dean Witter from raising the argument nor did it preclude the jury from considering and accepting the argument.

Finally, we reach the most disturbing allegation of all those contained in Dean Witter's motions, the allegation that Plaintiffs' counsel deliberately altered a jury instruction contrary to the Court's order. Dean Witter correctly notes that Plaintiffs' Instruction No. 16 (it was given and appears in the record as Instruction No. 14) as given differed in several respects from the instruction approved in the Court's conference with the attorneys the evening before closing arguments were to begin. As tendered to the Court, the pertinent portion of the proposed instruction read as follows:

> This case concerns one claim by Plaintiffs, Hudson T. Harrison and Harrison Construction, against Defendant, Dean Witter Reynolds, Inc. Plaintiffs claim that Defendant is jointly and severally liable to them under Section 20(a) of the Securities and Exchange Act for the securities fraud committed by Defendant's Vice President, John Kenning, and its registered sales person, John Carpenter.
>
> Plaintiffs claim that between March, 1985 and June 1986, Kenning and Carpenter violated Rule 10b-5 under the Securities and Exchange Act by convincing them, through a series of fraudulent misstatements and omissions, to invest over $4.0 million in a Dean Witter managed investment program. Plaintiffs claim that although Kenning and Carpenter misrepresented to them that the money would be invested in less risky municipal bonds, it was actually invested in far riskier stock options, and was eventually lost.

After hearing argument, the Court ordered the Plaintiff to modify the instruction by removing the words "less risky" and deleting the reference to "jointly and severally." Plaintiffs' counsel contends that early the following morning he obtained an agreement to substitute "municipal bonds" in place of the phrase "Dean Witter managed investment program." Dean Witter's counsel claims no such agreement was made and that the first time Dean

Witter noticed the alteration was in preparing its reply brief for the present motions. Thus, the Court is presented with a situation in which opposing counsel have effectively suggested that each has lied to this Court about the cause for this alteration of the instruction.

As truly disheartening and disturbing as this situation is, Dean Witter faces a tremendous set of hurdles in this argument. Dean Witter failed to object to the instruction despite having several opportunities to do so, including opportunities to object (1) at any time just prior to this Court's instructing of the jury, (2) at the time the instruction was read to the jury prior to closing argument, (3) at any time during closing argument or after closing argument, (4) at any time while the jury was deliberating, (5) at the time the jury delivered questions and the Court with counsels' agreement prepared responses to those questions and (6) in its opening motion and brief in its most recent submissions to the Court. These cumulative failures strongly suggest Dean Witter waived any objection to the instruction as given.

The Court would emphasize Dean Witter's failure is all the more startling given the nature of the jury's questions. In response to the jury's first question, this Court utilized language from the instruction and drafted a response that included a statement that "[t]he 10(b) violation relates to the representation of Kenning and/or Carpenter as to the municipal bonds." As the transcript clearly indicates, both counsel for Plaintiffs and for Dean Witter agreed to the language of this response. In response to another question from the jury, this Court re-read the language of the instruction that Dean Witter now challenges. After doing so, the Court asked counsel if they had any comments or problems with the Court's response to the jury. Again, Dean Witter failed to raise any problem to the Court's attention and did not object to the instruction.

According to Fed. R. Civ. P. 51, "[n]o party may assign as error the giving or the failure to give an instruction unless that party objects thereto before the jury retires to consider its verdict, stating distinctly the matter objected to and the grounds of the objection." A failure to properly object to an instruction results in a waiver of that objection. *O.K. Sand & Gravel v. Martin Marietta Technologies*, 36 F.3d 565, 568 (7th Cir. 1994). Under the circumstances, the Court finds Dean Witter failed to properly object and it has waived any claim of error resulting from the altered instruction. We decline to resolve the dispute between counsel as to the circumstances of the alteration of the instruction.

Upon review of the evidence presented in this case, the Court denies both Dean Witter's motion for judgment as a matter of law and Dean Witter's motion for a new trial. Having completed this task, we now turn to Plaintiffs' motion to alter or amend the judgment to include prejudgment interest. We also briefly consider Plaintiffs' bill of costs.

### *Prejudgment Interest and the Bill of Costs*

In any discussion of prejudgment interest in cases involving violations of federal law, a district court is bound to observe the Seventh Circuit's directive that "prejudgment interest [is] presumptively available to victims of federal law violations." *Gorenstein Enterprises, Inc. v. Quality Care-USA, Inc.*, 874 F.2d 431, 436 (7th Cir. 1989). Since *Gorenstein*, the Seventh Circuit has repeated the presumption on several occasions. Dean Witter, however, argues that the decision of whether to award prejudgment interest and, if so, in what amount lies within the discretion of this Court. Dean Witter relies on *Osterneck v. Ernst & Whinney*, 489 U.S. 169, 176 (1989) for the proposition that a district court must consider several factors to balance the equities of a case prior to awarding prejudgment interest. We find Dean Witter's reliance on *Osterneck* as a directive to district courts distressing. The issue presented in *Osterneck* was whether a postjudgment motion for prejudgment interest constituted a Rule 59(e) motion to alter or amend a judgment. The Court explicitly indicated that "[w]e do not intend here to specify what factors a district court must consider when deciding under federal law whether to grant prejudgment interest." 489 U.S. at 176 n.2. In a glaring absence of candor, Dean Witter fails to mention these obvious limitations on the scope of the *Osterneck* Court's holding.

More recently, the Seventh Circuit has questioned whether district courts have any discretion in awarding prejudgment interest, but assuming the courts do, that discretion is extremely limited. *Hutchison v. Amateur Electronic Supply*, 42 F.3d 1037, 1046 (7th Cir. 1994). For example, it is an abuse of discretion to deny prejudgment interest because the issue of liability was a close question, as it was in this case. *Id.* at 1046-47. On the other hand, the Seventh Circuit has considered excessive delay in filing of a suit a factor courts may consider. *In re Oil Spill by the Amoco Cadiz*, 954 F.2d 1279, 1334 (7th Cir. 1992). The Seventh Circuit has made it clear that the district courts are not to engage in a free-ranging exercise of "judicial impressionism." *Id.* at 1334.

As a result, this Court declines Dean Witter's invitation to engage in a broad review of the equities of this case.

At the same time, it is important to remember that the jury necessarily found Dean Witter acted recklessly in its supervision of Carpenter and Kenning. Furthermore, the jury also concluded that Plaintiffs did not bear substantially equal or greater responsibility for the violations they sought to redress. Thus, in terms of relative culpability, the jury sided with Plaintiffs, not Dean Witter, and we decline to revisit that issue under the guise of an exercise of discretion in awarding prejudgment interest.

As for delay in this litigation, we do not believe the record supports a finding that Plaintiffs created an excessive delay. Plaintiffs did ask for a stay as to Carpenter and Kenning because of their imprisonment but at the same time requested a Rule 54(b) order which would have allowed them to appeal the summary judgment entered in favor of Dean Witter. Judge Duff declined to issue the Rule 54(b) certification but stayed the matter as to Kenning and Carpenter anyway. While Plaintiffs could have chosen to voluntarily dismiss Carpenter and Kenning earlier, and perhaps could have moved for default or for summary judgment, we do not find their failure to do so warrants a denial of prejudgment interest.

Finally, a brief word on Dean Witter's tax benefits argument is in order. Dean Witter would have this Court calculate the tax benefits to Plaintiffs of deductions taken in 1985 and 1986 and reduce the award of prejudgment interest by corresponding amounts. First, other than Dean Witter's calculations, we have no basis to evaluate the alleged tax benefits nor the I.R.S. treatment of them. Plaintiffs maintain the I.R.S. has involved itself in this case which comes as no surprise to the Court.

According to Plaintiffs, they have reached a settlement with the I.R.S. The Court has no idea how the I.R.S. will treat the amount of this judgment given the prior deductions taken by Plaintiffs and apparently disputed by the I.R.S. The Court has great faith, however, that the I.R.S. will diligently discharge its duties to make sure Plaintiffs receive no unauthorized tax benefits. Under the circumstances, this Court declines to reduce the prejudgment interest by the amount of any asserted tax benefits to Plaintiffs.

Now, we come to the calculation of the amount of prejudgment interest. Dean Witter also disputes this calculation arguing that compound interest at the prime rate is not warranted because there was no significant risk of default given that Dean Witter is large, reputable firm. The Seventh Circuit cases teach that "compound interest is the norm in federal litigation." *Amoco Cadiz*, 954 F.2d at 1332. The rate of interest is the market rate, and for most purposes the prime rate is an adequate measure of the market rate. *Id.* Risk of default, however, is but one factor contributing to the market rate. Thus, we do not find the assertion that the risk of default was low in this case sufficient to reduce the rate or the method of compounding.

As for how often to compound, annually, monthly, daily, etc., there appears to be support in the law for each approach. This Court will adopt the approach taken by Judge Easterbrook, sitting by designation in a patent case, and will calculate the interest due by applying the average prime rate compounded monthly. *See In re Mahurkar Double Lumen Hemodialysis Catheter Patent Litig.*, 831 F. Supp. 1354, 1395 (N.D. Ill. 1993).

Because Dean Witter does not contest Plaintiffs' calculations, this Court will adopt them. Accordingly, the Court grants Plaintiffs' motion to alter or amend the judgment. The judgment shall be amended to reflect an award of prejudgment interest to Plaintiffs in the amount of $3,143,708.31. Finally, as to the Bill of Costs, Plaintiffs have conceded the objections raised by Dean Witter and have revised their request accordingly. Consequently, the Court will enter the revised Bill of Costs.

## CONCLUSION

For the reasons set forth above, the Court denies Dean Witter's motion for judgment as a matter of law and its alternative motion for a new trial. The Court grants Plaintiffs' motion to alter or amend the judgment and the judgment is hereby amended to award prejudgment interest to Plaintiffs in the amount of $3,143,708.31. Finally, the Clerk is directed to tax costs as provided in Plaintiffs' revised Bill of Costs.

ENTER:

/s/ GEORGE M. MAROVICH
UNITED STATES DISTRICT JUDGE

DATED: March 20, 1995

# UNITED STATES DISTRICT COURT
# NORTHERN DISTRICT OF ILLINOIS

Case Number: 86 C 8003 Date: March 21, 1995

Name of Assigned Judge: George M. Marovich

Case Title: Hudson T. Harrison v. Dean Witter
Reynolds, Inc.

* * * * *

DOCKET ENTRY:

* * * * *

(10) ☒ [Other docket entry] Pursuant to memorandum opinion dated March 20, 1995, Defendant's motion for judgment as a matter of law or for a new trial (296-1 & 2) is denied. Plaintiffs' motion to alter or amend judgment by adding prejudgment interest (293-1 & 2) is granted. The judgment is amended to award prejudgment interest to plaintiffs in the amount of $3,143,708.31.

(11) ☒ [For further detail see ☐ order on the reverse of ☒ order attached to the original minute order form.]

* * * * *

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
Eastern Division

HUDSON T. HARRISON and
HARRISON CONSTRUCTION, INC.

v.

DEAN WITTER REYNOLDS, INC.

Case Number:
86 CV 8003

## AMENDED JUDGMENT IN A CIVIL CASE

☒ Jury Verdict. This action came before the Court for a trial by jury. The issues have been tried and the jury has rendered its verdict.

☐ Decision by Court. This action came to trial or hearing before the Court. The issues have been tried or heard and a decision has been rendered.

IT IS ORDERED AND ADJUDGED that plaintiffs, HUDSON T. HARRISON and HARRISON CONSTRUCTION, INC., recover of defendant, DEAN WITTER REYNOLDS, INC. the sum of SIX MILLION FIVE HUNDRED EIGHTY-EIGHT THOUSAND FIVE HUNDRED FIFTY-SIX and 53/100 ($6,588,556.53), consisting of the jury award of $3,424,663.59, prejudgment interest in the amount of $3,143,708.31, and costs in the amount of $20,184.63.

March 21, 1995
*Date*

H. STUART CUNNINGHAM
*Clerk*

/s/
*(By) Deputy Clerk*

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

May 20, 1996

Before
Hon. HARLINGTON WOOD, JR., Circuit Judge
Hon. MICHAEL S. KANNE, Circuit Judge
Hon. ALLEN SHARP, Chief District Judge*

No. 95-1970

HUDSON T. HARRISON and
HARRISON CONSTRUCTION, INC.,

*Plaintiffs-Appellees,*

*v.*

DEAN WITTER REYNOLDS, INC.,

*Defendant-Appellant.*

Appeal from the United States District Court
for the Northern District of Illinois, Eastern Division.
No. 86 C 8003—George M. Marovich, *Judge.*

## ORDER

On consideration of the petition for rehearing, with suggestion of rehearing en banc, filed in the above-entitled cause by defendant-appellant on April 3, 1996, no judge in active service** has requested a vote thereon, and all of the judges on the original panel have voted to deny a rehearing. Accordingly,

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* The Honorable Allen Sharp, Chief Judge of the Northern District of Indiana, sitting by designation.

IT IS ORDERED that the aforesaid petition for rehearing, with suggestion of rehearing en banc, is hereby DENIED.

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** Judge Walter J. Cummings did not participate in the consideration of this petition.

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

May 30, 1996

Before
Hon. HARLINGTON WOOD, JR., Circuit Judge

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HUDSON T. HARRISON and
HARRISON CONSTRUCTION, INCORPORATED,
an Illinois corporation,

*Plaintiffs-Appellees,*

No. 95-1970 *v.*

DEAN WITTER REYNOLDS, INCORPORATED,

*Defendant-Appellant.*

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Appeal from the United States District Court
for the Northern District of Illinois, Eastern Division.
No. 86 C 8003—George M. Marovich, *Judge.*

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Upon consideration of:

1. "DEFENDANT-APPELLANT DEAN WITTER REYNOLDS INC.'S MOTION FOR A STAY OF MANDATE PENDING PETITION FOR WRIT OF CERTIORARI" filed on May 28, 1996, by counsel; and,
2. "PLAINTIFFS-APPELLEES' OPPOSITION TO MOTION FOR STAY OF MANDATE" filed on May 29, 1996, by counsel,

**IT IS ORDERED** that #1 is **DENIED.**

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

June 3, 1996

Before
Hon. HARLINGTON WOOD, JR., Circuit Judge

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HUDSON T. HARRISON and HARRISON CONSTRUCTION, INCORPORATED, an Illinois corporation,

*Plaintiffs-Appellees,*

No. 95-1970 *v.*

DEAN WITTER REYNOLDS, INCORPORATED,

*Defendant-Appellant.*

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Appeal from the United States District Court
for the Northern District of Illinois, Eastern Division.
No. 86 C 8003—George M. Marovich, *Judge.*

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The following is before the court:

1. DEAN WITTER'S MOTION FOR RECONSIDERATION filed on May 30, 1996, by counsel.

A supersedeas bond for the full judgment, including interest, was posted by Dean Witter on May 18, 1995, and was approved by the district court on June 1, 1995. Accordingly, the motion to reconsider is GRANTED and issuance of the mandate is hereby STAYED. If the Supreme Court denies Dean Witter's petition for a writ of certiorari, the mandate will issue forthwith.

The court further notes that, if the initial motion to stay the mandate had been untimely, the court would have addressed that issue in its May 30, 1996 order.

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

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Nos. 91-1458 & 91-1592

HUDSON T. HARRISON and HARRISON CONSTRUCTION INCORPORATED, a corporation,

*Plaintiffs-Appellants,*
*Cross-Appellees,*

*v.*

DEAN WITTER REYNOLDS, INCORPORATED,
a corporation,

*Defendant-Appellee,*
*Cross-Appellant.*

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Appeals from the United States District Court
for the Northern District of Illinois, Eastern Division.
No. 86 C 8003—**Brian Barnett Duff**, *Judge,*
and **George W. Lindberg**, *Judge.*

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ARGUED FEBRUARY 10, 1992—DECIDED SEPTEMBER 8, 1992

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Before KANNE, *Circuit Judge*, WOOD, JR., *Senior Circuit Judge*, and SHARP, *District Judge*.*

WOOD, JR., *Senior Circuit Judge*. For nearly eighteen months Hudson T. Harrison, an Illinois resident, sent his and his company's money to a Dean Witter Reynolds,

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* The Honorable Allen Sharp, Chief Judge, United States District Court for the Northern District of Indiana, sitting by designation.

Inc. ("Dean Witter") account executive and vice president, John G. Kenning, in Boca Raton, Florida, for investment in low-risk municipal bonds. Both Kenning and his assistant, John M. Carpenter, offered Harrison an opportunity he could not resist: If he sent money to them personally, they would place it in Carpenter's personal, employee account at Dean Witter and then invest it in a specially available, municipal-bond fund. This misuse of the employee account would yield Harrison a significantly increased return because the bonds would be purchased at Dean Witter's cost and at the reduced commission allowed on employees' own transactions. Dean Witter's rules prohibited using employee accounts in this manner.

All told, Mr. Harrison and his company, Harrison Construction Inc. (collectively "Harrison"), the plaintiffs-appellants here, invested roughly $4 million. A few payments, or investments, were made by wire transfer to Carpenter's personal checking account, but most were made by check, mailed to Carpenter's home. In return Harrison received personal, promissory notes signed initially by Carpenter and later by both Kenning and Carpenter. These notes offered annualized interest rates of approximately 18% to 60%. Dean Witter points out, however, that Harrison received two notes for each transaction: one accurately stated his anticipated return, and the other, which he used for income-tax purposes, materially understated it.

The scheme, however, was a fraud perpetrated by Kenning and Carpenter, who invested not in municipal bonds but in much riskier put options. These investments went sour. Harrison and roughly 125 other investors lost most of their money. Kenning and Carpenter were later sentenced to eight and four years' incarceration, respectively, in a federal penitentiary for their criminal acts and ordered to pay $8 million restitution.

Harrison sued not only Kenning and Carpenter but also Dean Witter, seeking to impose both vicarious and direct liability. He raised claims under Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. § 78j(b); Section 20(a) of the 1934 Act, 15 U.S.C. § 70t(a); the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. §§ 1961 *et seq.*; state common law; and one state statute. One of the RICO claims was dismissed early on. *Harrison v. Dean Witter Reynolds, Inc.*, 695 F. Supp. 959 (N.D. Ill. 1988). The other claims succumbed to Dean Witter's motion for summary judgment. *Harrison v. Dean Witter Reynolds, Inc.*, 715 F. Supp. 1425 (N.D. Ill. 1989). The case was then transferred from Judge Duff to Judge Lindberg, who imposed sanctions under Fed. R. Civ. P. 11 on Harrison's attorney, Thomas P. Ward, for raising two frivolous claims. *Harrison v. Dean Witter Reynolds, Inc.*, 132 F.R.D. 184 (N.D. Ill. 1990). These Rule 11 sanctions resulted in an award of attorney's fees in the amount of $20,860.50. *Harrison v. Dean Witter Reynolds, Inc.*, No. 86 C 8003, Memorandum Opinion and Order (N.D. Ill. Oct. 19, 1990). Kenning and Carpenter were then dismissed on Harrison's motion under Fed. R. Civ. P. 41(a), and final judgment was entered February 6, 1991. Harrison appeals the grant of summary judgment in favor of Dean Witter and the imposition of sanctions; Dean Witter appeals the partial denial of sanctions. For the reasons stated below we affirm in part and reverse in part.

## ANALYSIS

Diversity jurisdiction exists over the state-law claims. Plaintiff, Hudson T. Harrison, is a citizen of Illinois. Plaintiff, Harrison Construction, Inc., is an Illinois corporation with its principal place of business in Illinois. The defendant, Dean Witter, is a Delaware corporation with its principal place of business in New York. The former defendants, Kenning and Carpenter, were citizens of Florida. The amount in controversy exceeds $50,000. 28 U.S.C. § 1332. We reserve for the moment Dean Witter's contention that we do not have jurisdiction over the appeal with respect to the Rule 11 sanctions imposed.

We review *de novo* a district court's decision to grant summary judgment, viewing the facts in a light most favorable to the nonmoving party. *Prince v. Zazove*, 959 F.2d 1395, 1398 (7th Cir. 1992); *Ooley v. Schwitzer Division, Household Manufacturing Inc.*, 961 F.2d 1293, 1297 (7th Cir. 1992). "The movant has the burden of showing that there is no genuine issue of fact, but . . . [under Fed. R. Civ. P. 56(e) the nonmoving party] must set forth specific facts showing that there is a genuine issue for trial." *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 256 (1986). Where a party who bears the burden of proof fails to establish an essential element in its case, "there can be 'no genuine issue as to any material fact' . . . [and] all other facts [become] immaterial." *Celotex Corp. v. Catrett*, 477 U.S. 317, 322-33 (1986) (quoting Fed. R. Civ. P. 56(c)). *See also Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574, 585-87 (1986).

SECTION 20(a)[1]

The district court based its grant of summary judgment on the proposition of law that under Section 20(a) of the 1934 Act the plaintiff must show "the defendant exercised some control over the wrongdoer with respect to the wrongful acts." *Harrison v. Dean Witter Reynolds, Inc.*, 715 F. Supp. 1425, 1436 (N.D. Ill. 1989) (citing *Christoffel v. E.F. Hutton & Co.*, 588 F.2d 665, 668 (9th Cir. 1978)). This is known as the "culpable participant" requirement or test. *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1574-75 (9th Cir. 1990) (en banc), *cert. denied*, 111 S. Ct. 1621 (1991); *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 949 (7th Cir. 1989). The court then found, as a matter of law:

> Dean Witter exercised no control over Kenning and Carpenter with respect to their sales of promissory notes [(the allegedly fraudulent acts)]. It did not know of these sales, nor could it have known of them, since Carpenter and Kenning structured their arrangement with Harrison to ensure that Harrison would not send any money to them at the office. Further, the sales were conducted in the names of Kenning and Carpenter alone; the payments on the notes were by Carpenter's personal checks; and Harrison

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[1] Section 20(a) of the 1934 Act establishes liability as follows:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t.

> never contacted Dean Witter to inquire about his investments.

*Harrison*, 715 F. Supp. at 1437.

> In applying the culpable-participant test from *Christoffel*, the district court used a test we have never approved, a test, the rigors of which contravene our prior holdings, and a test expressly overruled, en banc, by the Court of Appeals for the Ninth Circuit in *Hollinger*, 914 F.2d at 1575.

In *Schlifke* we stated,

> This circuit has not crystallized the test for determining when liability may be imposed on a "controlling person," yet in *Barker* we stated that "the ability to persuade and give counsel is not the same thing as 'control', which almost always means the practical ability to *direct* the actions of the people who issue or sell the securities."

*Schlifke*, 866 F.2d at 949 (citing *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 494 (7th Cir. 1986); emphasis in *Barker*). We then stated, "We need not decide whether to adopt this more rigorous, ['culpable-participation'] formulation for the [defendant] Bank was not a 'controlling person' even under the less demanding *Metge* test." *Schlifke*, 866 F.2d at 949. In *Metge v. Baehler*, 762 F.2d 621 (8th Cir. 1985), *cert. denied*, 474 U.S. 1057; 474 U.S. 1072 (1986), the court had held:

> [P]laintiffs must establish, first, that the defendant lender actually participated in (*i.e., exercised* control over) the operations of the corporation *in general*; then he must prove that the defendant possessed the power to control the specific transaction or activity upon which the primary violation is predicated, but he *need not prove that this later power was exercised.* [Quotation marks and citation omitted.] We approve

> this test because it complies with precedents which counsel broad remedial construction of the statute and because it complies with precedents that distinguish between actual exercise of control in the violator's principal affairs and potential control over the violation.

*Metge*, 762 F.2d at 631 (first emphasis in original, others added).

While the *Schlifke* court clearly did not adopt the culpable-participation test, neither did it expressly adopt the two-pronged *Metge* test. The court did state, however, it agreed "fully with the district court's analysis," which utilized the *Metge* test. *Id.* at 949. Significantly, the control-person test approved in *Metge* was that used by the district court in *Metge v. Baehler*, 577 F. Supp. 810, 817-18 (S.D. Iowa 1984), which in turn applied elements stated in *Stern v. American Bankshares Corp.*, 429 F. Supp. 818 (E.D. Wis. 1977).

> There is no requirement that the controlling person exercise control over the particular transaction which gives rise to the violation. . . .
>
> . . . .
>
> What the plaintiff in this action must establish is that those persons whom he contends are controlling persons have actively participated in the operations of [defendant] Bankshares and possessed actual control over the transaction in question. Once that is established the matters of knowledge and actual participation, which directly or indirectly induced the fraud, are matters for the defense.

*Stern*, 429 F. Supp. at 823-24 (citations omitted). Moreover, the *Metge* test comports with the definition of "control" promulgated by the Securities and Exchange Commission ("SEC")[2] and, as we shall now see, with our prior holdings, which also counsel broad remedial construction of the statute and recognition of a practical ability to direct the actions of those involved.

In *SEC v. First Securities Co. of Chicago*, 463 F.2d 981 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972) ("*First Securities I*"), and a companion case, *SEC v. First Securities Co. of Chicago*, 466 F.2d 1035 (7th Cir.), *cert. denied*, 409 U.S. 1041 (1972) ("*First Securities II*"), we reversed the district court, which had disallowed a number of liability claims brought under Section 20(a). Leston B. Nay, president of First Securities and owner of 92% of its stock, had defrauded at least sixteen clients by inducing them to invest in spurious, high-interest, escrow accounts that, upon his suicide, June 4, 1968, were worthless. Typically, an investor would sell already owned securities through First Security; First Security would collect a commission on the sale and forward the remainder to the investor, who then would draw a personal check payable to Nay or to a bank for his account. Nay issued receipts that took the form of a purported agreement or promissory note from him. Erratically, Nay made what appeared to be interest payments to the investors by personal check in envelopes on which First Securities's name and address appeared. In *First Securities I*, 463 F.2d at 985, the court observed,

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[2] "The term 'control' (including the terms 'controlling,' 'controlled by' and 'under common control with') means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." 17 C.F.R. § 240.12b-2.

> Finally, it is clear that Nay had no actual authority to act for First Securities with regard to the escrow account. It is also clear that First Securities' employees (other than Nay) knew nothing of the nature of the escrow nor, except for his secretary, even of its existence. Nay had forbidden anyone other than himself to open mail addressed to him . . . .

The court concluded that it "had no doubt Nay, being the employee of First Securities as its president, was 'controlled' by First Securities within the intendment of section 20(a)." *Id.* at 987 (citation omitted). Moreover,

> First Securities made Nay its president, provided him with the trappings of a successful investment counsellor, held him out as providing such counsel, and then wilfully allowed Nay's enforcement of a rule regarding the opening of mail which was antithetical to the prevention of frauds of the type which occurred.

*Id.* at 988. After quoting this statement, the *First Securities II* court added, "First Securities also provided Nay with the printed letterheads, printed safekeeping receipts, rubber stamps and other supplies and accoutrements which enabled him to perpetrate and perpetuate his frauds." *First Securities II*, 466 F.2d at 1040.

In *Sennott v. Rodman & Renshaw*, 474 F.2d 32 (7th Cir.), *cert. denied*, 414 U.S. 926 (1973), we reversed a district court's finding of brokerage-house liability where no one at the brokerage itself had participated in the fraudulent acts. The actual fraud was committed by Jordan Rothbart some six years after he left the brokerage firm of Rodman & Renshaw. He became a commodities trader and member of the Chicago Board of Trade, where he met the plaintiff, Sennott, to whom he purported to sell $142,000 in stock options which, it turned out, never existed. The court found, however, that Rothbart's other transactions with Sennott, had they been fraudulent, would have imposed liability on Rodman & Renshaw under Section 20(a). As described by the court,

> A typical [non-fraudulent] transaction involved Jordan [Rothbart] advising Sennott that his father[, William, a registered representative of Rodman & Renshaw,] believed a particular stock should be bought or sold, Sennott indicating a desire to purchase, and Jordan going to the Rodman phone on the Board of Trade floor and calling in the order. Shortly thereafter Sennott would receive a mailed confirmation slip from Rodman. Sennott, of course, paid brokerage fees on all of these transactions.

*Sennott*, 474 F.2d at 34 (footnote omitted). The court concluded that while Rodman & Renshaw could be held liable under Section 20(a) for the just-described transactions, there was

> not an adequate foundation upon which to base liability where Rodman was admittedly not considered to be involved in the transaction. Rodman's duty to control its partners and agents, as well as its past employees, in situations such as this extends only to transactions with or by these parties where Rodman is itself involved.

*Id.* at 39-40.

*In Henricksen v. Henricksen*, 640 F.2d 880 (7th Cir.), *cert. denied*, 454 U.S. 1097 (1981), we reversed a district court's finding that a brokerage firm, Smith Barney, was liable under Section 20(a) for the fraudulently garnered commissions and margin expenses but not for the conversions by its salesman-agent, George Henricksen. We held Smith Barney was liable for the conversions, too.

> Having entrusted her investment to Smith Barney's management through George [Henricksen], their

> agent, Wendee [Henricksen, George's former wife,] was entitled to rely on Smith Barney's fiduciary obligation to manage the investments in accordance with her recorded investment objectives and George's best professional judgment subject to the review and ultimate control of Smith Barney's supervisory personnel.

*Henricksen*, 640 F.2d at 888.

Lastly, we have affirmed a finding by the Commodity Futures Trading Commission that a commodity brokerage firm, Rosenthal & Company, was liable under Section 2(a) of the Commodity Exchange Act for the fraudulent acts of a non-employee who was, nevertheless, a manager, associate, and registered representative of the firm. 7 U.S.C. § 4; *Rosenthal & Company v. Commodity Futures Trading Commission*, 802 F.2d 963 (7th Cir. 1986). Of particular relevance for us is the observation in *Rosenthal* that, although we affirmed the Commission's finding of liability, we could have, with equal justification, affirmed a finding that Rosenthal was not liable.

> [W]e don't suppose that we or any other court would think the Commission had taken leave of its senses [had it accepted Rosenthal's line of argument]. But we also think the Commission was entitled, without being deemed to have acted unreasonably or without substantial evidence, to conclude that [co-defendant] Pinckney was acting within the scope of his agency [with Rosenthal].

*Id.* at 968. The issue was factual, and it was the factfinder's choice to find liability or not.

Those cases in which we have found control wanting help define the boundaries of "control person." In *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490 (7th Cir. 1986), we affirmed that neither the law firm which had provided legal advice nor the accounting firm which had furnished accounting services with regard to certain bonds were control persons. Neither firm had the ability to control the bond issuer; both firms had only the "ability to persuade and give counsel[, which] . . . is not the same thing as 'control.'" *Id.* at 494. Neither firm had the authority to direct the actions of the bond issuer; additionally, neither had received the selling materials until after they were issued. *Id.* In *Sennott* there was no liability because there was no person which the brokerage firm could control; the fraud involved no member or representative of the firm. Rather, it was the non-fraudulent transactions which could have brought liability to the firm; one of its members did participate in the transactions, and the firm, inter alia, received attendant commissions.

In *Schlifke*, we affirmed a grant of summary judgment for the defendant, the parent corporation of a bank that had made a loan, secured by letters of credit, to an oil-and-gas limited partnership. The loan documents appeared in the prospectus. We found that the bank "had no power to control the . . . sales personnel or to dictate the manner in which the allegedly fraudulent sales of securities were made; it merely prescribed requirements for the letters of credit . . . ." *Schlifke*, 866 F.2d at 950. In a diversity action arising under the Illinois Securities Law of 1953, ILL. REV. STAT. ch. 121 1/2, §§ 137.1 *et seq.*, we affirmed a district court's finding that the broker and its salesperson were jointly and severally liable and that the clearing agent, Bear, Stearns, was not:

> [A]s the clearing agent in these transactions, Bear, Stearns did not play a central or specialized role. Instead, it performed a simple, albeit necessary, ac-

> counting function in order to process the orders. We will not impose the broad liability reserved under the Illinois Act for underwriters, dealers or salespersons for the performance of such limited, ministerial acts.

*Carlson v. Bear, Stearns & Co.*, 906 F.2d 315, 317 (7th Cir. 1990). The point is well made.

Clearly, we have never approved or used the culpable-participant test, nor have we ever used any similar test to so stingily limit the definition of control person. Moreover, the court of appeals that Judge Duff unfortunately relied upon as precedent for the culpable-participant test has, since, expressly rejected that test and has, instead, adopted a test which greatly expands Section 20(a)'s circle of liability.

The Court of Appeals for the Ninth Circuit, sitting en banc, reversed a district court's summary judgment for the defendant and held "that a broker-dealer is a controlling person under § 20(a) with respect to its registered representatives." *Hollinger*, 914 F.2d at 1573. In so doing, the court overruled prior decisions in *Christoffel*, the case relied upon by Judge Duff, and *Buhler v. Audio Leasing Corp.*, 807 F.2d 833 (9th Cir. 1987), among others. The court expressly rejected the "culpable participation" test of control (*Hollinger*, 914 F.2d at 1575), stating, instead, that a plaintiff "need only show that . . . [the actor] was not himself a registered broker-dealer but was a representative employed by or associated with a registered broker-dealer." *Id.* at 1574. But as the court explained:

> [W]e do not mean that a broker-dealer is vicariously liable under § 20(a) for all actions taken by its registered representatives. Nor are we making the broker-dealer the "insurer" of its representatives . . . . [T]he

> "controlling person" can avoid liability if she acted in good faith and did not directly or indirectly induce the violations.

*Id.* at 1575. In a footnote the court observed,

> The broker dealer may also, of course, rely on a contention that the representative was acting outside the broker-dealer's statutory "control." For example . . . [the plaintiff was] placing the money with . . . [the actor] for purposes other than investment in markets to which [the actor] had access only by reason of his relationship with [the] broker-dealer . . . .

*Id.* at 1575-76 n.26.

We have long viewed the statute as remedial, to be construed liberally, and " 'requiring only some indirect means of discipline or influence short of actual direction to hold a "control person" liable.' " *First Securities I*, 463 F.2d at 987 (quoting *Myzel v. Fields*, 386 F.2d 718, 738 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968), which was cited for the same proposition by *Metge*, 762 F.2d at 630). We have never construed "control" as narrowly as the district court below, nor have we construed it as broadly as the court in *Hollinger*. We have looked to whether the alleged control-person actually participated in, that is, exercised control over, the operations of the person in general and, then, to whether the alleged control-person possessed the power or ability to control the specific transaction or activity upon which the primary violation was predicated, whether or not that power was exercised.

Here Harrison alleged and Dean Witter has not disputed that Dean Witter is a broker-dealer and that Kenning and Carpenter were its employees—the former as a registered representative, vice president, and account executive and the latter as a registered representative and Kenning's assistant. Additionally, both had assigned office-space at the Boca Raton branch of Dean Witter, a local, office telephone number, an "800" telephone number, and "Dean Witter" business cards, among other indicia of authority. Carpenter but not Kenning, who was facing bankruptcy, maintained an employee account at Dean Witter; Kenning actually controlled it, however. Dean Witter's rules required the local branch manager to sign all order tickets for employee accounts and to monitor the accounts' activities; the rules also prohibited commingling employee and client funds as well as sharing an interest in an account with anyone other than a close relative. Nonetheless, Harrison's money, sent to Kenning and Carpenter either at home or to a personal bank account, always landed rather quickly in Carpenter's account at Dean Witter.

The alleged facts are sufficient to prevent our finding, as a matter of law, either that Dean Witter did not actually exercise control over the operations of Kenning and Carpenter in general or that Dean Witter did not possess the power or ability to control Kenning and Carpenter's transactions upon which the primary violation is predicated. Accordingly, it was error to grant Dean Witter's motion for summary judgment on the basis that Dean Witter was not a controlling person. We leave that determination to the factfinder.

But the analysis does not end here. The statute provides an affirmative defense for controlling persons, one which the defendant bears the burden of proving. *Fey v. Walston & Co.*, 493 F.2d 1036, 1051-52 (7th Cir. 1974); *Hollinger*, 914 F.2d at 1575 n.25 (citing, inter alia, *Fey*, 493 F.2d at 1051-52). Section 20(a) of the 1934 Act provides that a controlling-person defendant is not liable if the defendant can show he or she "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." 15 U.S.C. § 78t. Thus, once controlling-person status is shown, "a broker-dealer would be liable for its employee's acts under Section 20(a) if it 'did not maintain a reasonably adequate system of internal supervision and control over the [registered representative] or did not enforce with any reasonable diligence such system * * * .' " *Henricksen v. Henricksen*, 640 F.2d 880, 884 (7th Cir.), *cert. denied*, 454 U.S. 1097 (1981) (quoting *Fey*, 493 F.2d at 1051; bracketed material and asterisks added by the *Henricksen* court). In affirming the district court's finding of liability, the *Henricksen* court held, inter alia,

> We cannot agree, however, that Smith Barney was reasonably diligent in its supervision of the trading in . . . [the plaintiff's] account, and we further conclude that this lack of reasonable diligence in combination with the generally casual supervision of . . . [the defendant employee's] activities contributed not only to the trading losses and commission expenses but to the conversions as well.

*Id.* at 885.

The alleged facts indicate Dean Witter had rules in place to prevent various types of fraud. For example, in addition to those noted above, the rules also required that supervisors ensure an employee's investments were commensurate with his or her resources. Indeed, on more than one occasion the head of Dean Witter's compliance department asked the local branch manager to investigate the heavy volume in Carpenter's account. He did ask Carpenter and Kenning about it, but apparently accepted without further investigation Carpenter's explanation that it was his own money. *Harrison*, 715 F. Supp. at 1425. As it turned out, the two lost some $600,000 in roughly their first year at Dean Witter and some $2,000,000 over the ensuing two years without attracting, what they might consider, unwarranted attention. Under the alleged facts of the present case we cannot say, as a matter of law, that Dean Witter acted in good faith and neither directly nor indirectly induced the act or acts constituting the violation. This determination, too, must be left to the factfinder.

## CHOICE OF LAW

The district court applied Illinois law to all state-law claims Harrison raised. He argues this was error and that Florida law controls these claims. Dean Witter responds that Harrison failed to object to the district court's applying Illinois law and, thus, cannot raise this issue on appeal.

Under *Erie and Klaxon* a federal court exercising diversity jurisdiction "must look to the law of the forum in which it sits for substantive law, . . . including the rules governing choice of law." *International Administrators, Inc. v. Life Insurance Co. of North America*, 753 F.2d 1373, 1376 n.4 (7th Cir. 1985) (citing *Erie Railroad Co. v. Tompkins*, 304 U.S. 64, 71-80 (1938), and *Klaxon Co. v. Stentor Electric Manufacturing Co., Inc.*, 313 U.S. 487, 496 (1941)). However, where, on the record, neither party objected to the district court's choice of law, "it is not open to us to reconsider that issue, absent some compelling reason of policy." *International Administrators*, 753

F.2d at 1376 (footnote omitted). Moreover, if neither party argues for application of a particular state's law, the law of the forum is presumptively applied. *Wood v. Mid-Valley Inc.*, 942 F.2d 425, 426 (7th Cir. 1991). Harrison cites no objection made on the record and does not claim to have otherwise raised the issue before the judge,[3] and the district court did apply the law of the forum state, Illinois. Accordingly, Harrison has waived the issue on appeal, and, under the circumstances, the court did not err in applying Illinois law to all of the state-law claims, whether they sought to impose direct or vicarious liability.

Harrison, nonetheless, argues he adequately raised the choice-of-law question in his first amended complaint in Counts X and XII. Harrison claims his reference in Count X (denominated, simply, "Conversion"), paragraph 85(a), to his prayer for "three-fold" damages identifies a sufficient argument for applying Florida law because Illinois has no comparable damages provision.[4] This argument is not sufficient to survive the rule of waiver. Neither has he presented a "compelling reason of policy" for applying Florida law by arguing that Florida allows a treble-damage award for conversion and Illinois does not. Furthermore, in relying solely on a damages argument he ignores the necessary predicate, a finding of liability, and consequently, has not made the requisite argument that there is a "compelling reason of policy" to apply the Florida law of liability rather than the Illinois law. In Count XII Harrison did cite FLA. STAT. ch. 517.211 and 517.301, but, as in most of the other counts, he does not seek to impose direct liability on Dean Witter. Rather, he seeks to impose vicarious liability for the acts of Kenning and Carpenter via *respondeat superior*. Thus, Harrison must show he also preserved the choice-of-law question with respect to the law of agency. This he has not done.

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[3] At oral argument Harrison's attorney, who was also the attorney below, acknowledged that, before Judge Duff, which state's law applied was "[n]ever contested. . . . No argument by them; no argument by us on it."

[4] Harrison also argues that in Count X, paragraphs 62-67, of his original complaint he expressly identified the Florida Civil Theft Act, FLA. STAT. ch. 812.014(1). If anything, this argument is detrimental, because the express citation is nowhere to be found in Count X or any other count of the first amended complaint or, apparently, anywhere else in the record on appeal. At least, Harrison does not claim to have expressly cited that statute elsewhere.

## *RESPONDEAT SUPERIOR*

Finding the undisputed facts did not support Harrison's claim that Kenning and Carpenter had either actual or apparent authority from Dean Witter for their fraudulent acts, the district court granted Dean Witter summary judgment on the issue of *respondeat superior*. Harrison appeals only with respect to the issue of apparent authority but adds arguments that Kenning and Carpenter were acting within the scope of their employment and that their being employees or servants of Dean Witter subjects Dean Witter to "status-based" liability.

Because we agree with the district court that, as a matter of law, neither Kenning nor Carpenter bore the mantle of apparent authority, Harrison's two additional arguments fail. The first argument fails because Kenning and Carpenter had no authority to commit the fraud and neither one was seeking to benefit the employer.[5] Thus, they were acting outside the scope of their employment. The second argument fails because it requires a showing that the agent was "apparently acting within his authority," and, as we shall now see, neither Kenning nor Carpenter were. Restatement (Second) of Agency § 261.

A recent decision of the Illinois Supreme Court, unfortunately not available to the parties before briefing, well summarizes the law of agency with respect to apparent authority.

> It is a well-established precept of agency law that a principal will be bound by the authority he *appears* to give to another, as well as the authority which he actually gives. Apparent authority arises where a principal creates, through words or conduct, the reasonable impression that the putative agent has been granted authority to perform certain acts. Apparent authority is that authority which a reasonably prudent person, in view of the principal's conduct, would naturally suppose the agent to possess.

*State Security Insurance Co. v. Burgos*, 145 Ill.2d 423, 164 Ill. Dec. 631, 583 N.E.2d 547, 551 (1991) (summary judgment finding apparent authority affirmed; citations omitted including two cited by Harrison; emphasis in *Burgos*).

As stated earlier by the Illinois Supreme Court, "The theory of apparent authority rests on two premises: a manifestation by the principal to a third party, and belief by that third party that the extent of the authority granted to the agent encompasses the contemplated activity." *Simpson v. Compagnie Nationale Air France*, 42 Ill. 2d 496, 248 N.E.2d 117, 120 (1969) (citing Restatement (Second) Agency § 8).[6] Also citing Restatement (Second) Agency, but at Section 261, Comment *a*, the Supreme Court similarly observed:

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[5] While it may be argued that Dean Witter received commissions on the activity Carpenter's account generated, it must be noted the commissions would have been greater had the activity been in a regular customer's account.

> Under an apparent authority theory, '[l]iability is based upon the fact that the agent's position facilitates the consummation of the fraud, in that from the point of view of the third person the transaction seems regular on its face and the agent appears to be acting in the ordinary course of the business confided to him.'

*American Society of Mechanical Engineers, Inc. v. Hydrolevel Corp.*, 456 U.S. 556, 566 (1982). Clearly, an essential element is the third party's reasonable belief that the agent is acting within the authority granted by the principal, that the transaction appears to be regular and in the ordinary course of business. That element is missing from Harrison's case.

Here the undisputed facts show Harrison did not open an account with Dean Witter but, instead, transferred money to Kenning and Carpenter for them to place in Carpenter's employee account at Dean Witter for subsequent investment. In so doing, Harrison expected to enhance his return by paying the lower commission charged Dean Witter employees, although he was not an employee entitled to that benefit. It is clear neither Kenning nor Carpenter had the authority, either actual or apparent, to use the account thusly; Dean Witter's rules expressly forbad it, as would ordinary prudence.

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[6] In the first decade of this century the Illinois court had held: "It rested upon the plaintiff to affirmatively show that [the act] . . . was within the apparent scope of the authority of the [employee] . . . and that he did not know or have reasonable grounds to believe that the [employee] was exceeding his authority." *Illinois Central Railroad Co. v. Jennings*, 217 Ill. 140, 75 N.E. 457, 459 (1905).

We cannot nor can any reasonably prudent person naturally suppose that Kenning and Carpenter possessed the authority to use the employee account for Harrison's benefit. It simply is not believable that their authority would extend so far. Furthermore, Harrison's transactions with Kenning and Carpenter were not regular on their face and could not appear to be within the ordinary course of business, within the ordinary course of their business, at Dean Witter.

Therefore, we hold the district court correctly found Dean Witter was not liable under *respondeat superior* for any of the state-law, vicarious liability claims Harrison raised.

## NEGLIGENT HIRING AND RETENTION

Illinois, in *Tatham v. Wabash Railroad Co.*, 412 Ill. 568, 107 N.E.2d 735 (1952), recognized an employee's intentional tort as a basis for the tort of negligent hiring and retention. *Becken v. Manpower, Inc.*, 532 F.2d 56, 58 (7th Cir. 1976); *Bates v. Doria*, 150 Ill. App. 3d 1025, 104 Ill. Dec. 191, 195, 502 N.E.2d 454, 458 (2nd Dist. 1986). Accordingly, "an employer is liable for hiring and retaining unfit and incompetent employees . . . where there has been an intentional tort or criminal conduct by the employee." *Martin v. Yellow Cab Co.*, 208 Ill. App. 3d 572, 153 Ill. Dec. 503, 508, 567 N.E.2d 461, 466 (1st Dist.

1990) (citation omitted); *Tatham*, 107 N.E.2d at 739. This is a negligence tort; thus, "the plaintiff's allegations must establish (1) the existence of a duty of care owed by the defendant to the plaintiff, (2) a breach of that duty, and (3) injury to plaintiff (4) proximately resulting from the breach." *Puckett v. Mr. Lucky's Ltd.*, 175 Ill. App. 3d 355, 125 Ill. Dec. 93, 96, 529 N.E.2d 1169, 1172 (4th Dist. 1988) (Knecht, J., dissenting; citations omitted); *see also McLane v. Russell*, 131 Ill.2d 509, 137 Ill. Dec. 554, 556-57, 546 N.E.2d 499, 501-02 (1989). "The existence of a duty is a question of law to be determined by the court" (*Puckett*, 125 Ill. Dec. 96, 529 N.E.2d at 1172 (Knecht, J., dissenting; citation omitted)), but it remains "for the trier of fact to determine if that duty was breached." *Pippin v. Chicago Housing Authority*, 78 Ill.2d 204, 35 Ill. Dec. 530, 399 N.E.2d 596, 600 (1979).

Here the district court found Dean Witter had no duty to protect Harrison from the wrongdoing of its employees, Kenning and Carpenter. Thus, the court entered judgment as a matter of law in favor of Dean Witter. We review *de novo* (*Salve Regina College v. Russell*, 111 S. Ct. 1217 (1991)) and agree that Dean Witter did not owe Harrison the common-law duty claimed.

Illinois courts have regularly held that, for a duty of care to exist, the plaintiff and defendant must stand "in such a relationship to one another that the law impose[s] upon the defendant an obligation of reasonable conduct for the benefit of the plaintiff." *McLane*, 137 Ill. Dec. 557, 546 N.E.2d at 502. Illinois courts have found a claim of negligent hiring and retention adequately stated, reversed a dismissal or summary judgment for the defendant, or affirmed a verdict for the plaintiff where the lowing relationships existed:[7] (1) the plaintiff is an employee of the defendant (*Tatham*, 107 N.E.2d 735); (2) the plaintiff contracted for defendant's services (*Becken*, 532 F.2d 56; *Easley v. Apollo Detective Agency, Inc.*, 69 Ill. App. 3d 920, 26 Ill. Dec. 313, 387 N.E.2d 1241 (1st Dist. 1979) (tenant raped by guard employed by agency employed by landlord to provide security)); (3) the plaintiff is the defendant landlord's tenant or the social guest of a tenant (*Pippin*, 399 N.E.2d 596; *Cross v. Wells Fargo Alarm Services*, 82 Ill. 2d 313, 46 Ill. Dec. 121, 412 N.E. 2d 472 (1980); *Phillips v. Chicago Housing Authority*, 89 Ill.2d 122, 59 Ill. Dec. 281, 431 N.E.2d 1038 (1982)); and (4) the plaintiff is the social guest of the defendant host (*Gregor v. Kleiser*, 111 Ill. App. 3d 333, 67 Ill. Dec. 38, 443 N.E.2d 1162 (2nd Dist. 1982)). Additionally, we have noted that while Illinois does not generally

> impose a duty to protect others from criminal attacks [(and, we might now add, acts)] by third parties, . . . the Illinois courts have recognized exceptions to this rule where the criminal attack was reasonably foreseeable and the parties had a 'special relationship:'

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[7] In *Malorney v. B & L Motor Freight, Inc.*, 146 Ill. App. 3d 265, 100 Ill. Dec. 21, 496 N.E.2d 1086, 1089 (1st Dist. 1986) (17-year-old plaintiff-hitchhiker repeatedly raped and assaulted in sleeper cab of truck by its driver), the court found the employer had a "duty to hire a competent driver who was to be entrusted with a . . . [sleeper-equipped,] over-the-road truck" and, accordingly, affirmed the trial court's denial of defendant's motion for summary judgment. The duty found in *Malorney* was based in part on the observation that truck drivers "are prone to give rides to hitchhikers despite rules [to the contrary]" and incorporated the concept of entrustment. *Id.* at 1089. Harrison has raised neither the issue of widespread propensity to violate brokerage-house rules nor the issue of entrustment.

> (1) carrier-passenger, (2) innkeeper-guest, (3) business invitor-invitee, or (4) voluntary custodian-protectee.

*Figueroa v. Evangelical Covenant Church*, 879 F.2d 1427, 1430 (7th Cir. 1989) (citations omitted).

The undisputed facts show no special, duty-creating relationship existed between Dean Witter and Harrison. Harrison had no account at Dean Witter. Moreover, no alleged fact indicates he was ever a customer of, had ever purchased a security from, or had ever placed an investment with the Boca Raton branch of Dean Witter. Thus, even if Dean Witter were negligent in hiring and retaining Kenning or Carpenter, no duty arose under the circumstances here.

## RULE 11 SANCTIONS

The district court imposed sanctions under Fed. R. Civ. P. 11 on Harrison's attorney, Thomas P. Ward, in the amount of $20,860.50 in attorney's fees for raising two frivolous claims: Count III, the claim under Section 1962(c) of RICO, which the court dismissed early on, and Count V, the claim on the promissory notes. Dean Witter had sought sanctions on the other counts, too, claiming all were frivolous, but the court declined. Both Harrison and Dean Witter appealed.

Dean Witter points out that Harrison did not name Ward as an appellant in its notice of appeal, otherwise timely filed on March 1, 1991, and argues that under *Torres v. Oakland Scavenger Co.*, 487 U.S. 312 (1988), we lack jurisdiction on this portion of the appeal for appellants' failure to comply with the requirement of Fed. R. App. P. 3(c). That rule states, "The notice of appeal shall specify the party or parties taking the appeal . . . ." *Torres*, 487 U.S. at 314, held, "The failure to name a party in a notice of appeal is more than excusable 'informality'; it constitutes a failure of that party to appeal." While Fed. R. App. P. 3(c) also provides, "An appeal shall not be dismissed for informality of form or title of the notice of appeal," it was of no avail to the party in *Torres*: "But although a court may construe the Rules liberally in determining whether they have been complied with, it may not waive the jurisdictional requirements of Rules 3 and 4, even for 'good cause shown' under Rule 2, if it finds that they have not been met." *Torres*, 487 U.S. at 317.

We have stated, "*Torres* made the requirements of Rule 3(c) inflexible." *FTC v. Amy Travel Service, Inc.*, 875 F.2d 564, 577 (7th Cir.), *cert. denied*, 493 U.S. 954 (1989). We have no jurisdiction over an appeal or that part of an appeal where the party taking the appeal is not named in the notice of appeal. *Id.* Because attorneys sanctioned by the district court are the real parties in interest, "the attorneys must appeal in their own names." *Rogers v. National Union Fire Insurance Co.*, 864 F.2d 557, 560 (7th Cir. 1988) (citation omitted). This attorney Ward did not do.

Appellants argue, however, that upon discovery of this error they filed a motion to amend the notice of appeal under Fed. R. App. P. 27. They find support for our granting their motion in a statement in *Torres* that the party there had not sought to amend the defective notice of appeal. The *Torres* Court actually stated, "Nor did petitioner seek leave to amend the notice of appeal within the time limits set by Rule 4." *Torres*, 487 U.S. at 317. Fed. R. App. P. 4(a)(1) requires the notice of appeal be filed within "30 days after the date of entry of the judgment or order appealed from . . . ." Rule 4(a)(5) permits the district court to

> extend the time for filing of a notice of appeal upon motion filed not later than 30 days after the expiration of the time prescribed by this Rule 4(a). . . . No such extension shal' exceed 30 days past such prescribed time or 10 days from the date of entry of the order granting the motion, whichever occurs later.

As made clear in *United States ex rel. Leonard v. O'Leary*, 788 F.2d 1238, 1239 (7th Cir. 1986), Rule 4(a)(5) grants a grace period of no more than thirty days beyond the initial 30-day deadline. Here appellants' motion to amend was filed June 10, 1991, 124 days after the entry of final judgment on February 6, 1991, 101 days after the errant notice of appeal was filed, and 94 days after the last day to file its notice of appeal, which under Rule 4(a)(1) was March 8, 1991. Appellants did not seek to amend their notice of appeal "within the time limits set by Rule 4." Accordingly, we have jurisdiction over neither their motion to amend nor that portion of the appeal challenging the district court's imposition of Rule 11 sanctions on attorney Ward.

On cross-appeal Dean Witter, citing Fed. R. Civ. P. 11 and 28 U.S.C. § 1927, argues it was improperly denied sanctions in the form of attorney's fees on the other claims raised by Harrison: namely, Counts I, II, IV, and VI through XII. Whether to award sanctions is within the discretion of the district court, and, accordingly, we review the district court's decision only for abuse of discretion. *Cooter & Gell v. Hartmarx Corp.*, 496 U.S. 384, 405 (1990); *Kotsilieris v. Chalmers*, 966 F.2d 1181, 1183 (7th Cir. 1992).

Dean Witter first argues that it was denied a proper hearing on its motion for sanctions because the motion was heard by a judge other than the one that handled earlier aspects of the case, including defendant's motion for summary judgment. Dean Witter does not, however, find the sanctions that were awarded by this latter judge similarly tainted. The contention, without more, is clearly without merit. *See Automatic Liquid Packaging, Inc. v. Dominik*, 909 F.2d 1001, 1006 (7th Cir. 1990) (In deciding a Rule 11 motion, it is not improper for a district court judge to rely on events that occurred before another judge and that are discoverable only by reviewing the record.).

In a carefully detailed, well reasoned opinion, Judge Lindberg found that, except for Counts III and V, Harrison's claims were neither frivolous nor raised for improper purposes. The court observed that, although the law was otherwise, Dean Witter seemed to argue that its having won the summary judgment motion proved the plaintiffs had not conducted a reasonable inquiry into the law and the facts. *See Mars Steel Corp. v. Continental Bank N.A.*, 880 F.2d 928, 932 (7th Cir. 1989) (en banc) ("Rule 11 focuses on inputs rather than outputs, conduct rather than results."), and *Prochotsky v. Baker & McKenzie*, 966 F.2d 333 (7th Cir. 1992) (district court's award of summary judgment for defendant and concomitant denial of Rule 11 sanctions affirmed). Dean Witter raises the same, impecunious argument here, and others, too. We have carefully reviewed the district court's findings and the record. We cannot find that the district court abused its discretion, and, therefore, we affirm its partial denial of sanctions.

Lastly, claiming Harrison's appeal of sanctions was frivolous because of the obvious, undisputable jurisdictional bar, Dean Witter asks for sanctions under Fed. R. App. P. 38. Dean Witter points out that it had advised attorney Ward by letter, long ago, both of the jurisdictional bar and that it would seek sanctions if he persisted. He, obviously, persisted, but we deny Dean Witter's motion. The appeal was not frivolous.

## CONCLUSION

We reverse the district court's grant of summary judgment with respect to the claim raised under Section 20(a) of the Securities Exchange Act of 1934 and remand for further proceedings, but we affirm the remainder of the district court's judgments and orders. For want of jurisdiction, we dismiss appellants' appeal on the imposition of Rule 11 sanctions.

Parties shall bear their own costs.

AFFIRMED IN PART,
REVERSED IN PART AND REMANDED,
and DISMISSED IN PART.

A true Copy:
Teste:

*Clerk of the United States Court of Appeals for the Seventh Circuit*

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

## JUDGMENT—WITH ORAL ARGUMENT

Date: September 8, 1992

BEFORE:

Honorable MICHAEL S. KANNE, Circuit Judge
Honorable HARLINGTON WOOD, JR., Senior Circuit Judge
Honorable ALLEN SHARP, District Judge*

Nos. 91-1458 and 91-1592

HUDSON T. HARRISON and HARRISON CONSTRUCTION, INCORPORATED, a corporation,

*Plaintiffs-Appellants,*
*Cross-Appellees,*

v.

DEAN WITTER REYNOLDS, INCORPORATED, a corporation,

*Defendant-Appellee,*
*Cross-Appellant.*

Appeals from the United States District Court
for the Northern District of Illinois, Eastern Division.
No. 86 C 8003—Judge George W. Lindberg,
and Judge Brian Barnett Duff.

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* The Honorable Allen Sharp, Chief Judge, United States District Court for the Northern District of Indiana, sitting by designation.

This cause was heard on the record from the above mentioned District Court, and was argued by counsel.

On consideration whereof, IT IS ORDERED AND ADJUDGED by this court that the district court's grant of summary judgment with respect to the claim raised under Section 20(a) of the Securities Exchange Act of 1934 is REVERSED and REMANDED for further proceedings, but the remainder of the district court's judgments and orders are AFFIRMED. The appellant's appeal on the imposition of Rule 11 sanctions is DISMISSED for want of jurisdiction. Parties shall bear their own costs. The above is in accordance with the decision of this court entered this date.

[Dated June 28, 1989]

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 86 8003

HUDSON T. HARRISON AND HARRISON CONSTRUCTION, INC., a corporation,

Plaintiffs,

v.

DEAN WITTER REYNOLDS, INC., a corporation, JOHN M. CARPENTER, and JOHN G. KENNING,

Defendants.

## MEMORANDUM OPINION

Plaintiffs Hudson T. Harrison and Hudson T. Harrison, Inc. have sued Dean Witter Reynolds, Inc. ("Dean Witter") and two of its broker-dealers, John M. Carpenter and John G. Kenning, under §10(b) of the Securities Exchange Act of 1934 ("the Securities Exchange Act"), 15 U.S.C. §78j(b) ("§10(b)"), §20(a) of the Securities Exchange Act, 15 U.S.C. §78t(a) (§20(a)"), the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. §§1961 et seq., and a number of state laws. Dean Witter has moved for summary judgment on all claims.

## DISCUSSION

This case contains two stories. The first story is about Dean Witter, and how it allowed Kenning and Carpenter to use its name and its office as part of a massive scheme to defraud investors. The second story is about Harrison, about how he threw millions of dollars at Kenning and Carpenter in the hopes of securing spectacular returns with no risk, and found himself millions of dollars poorer for his greed. Viewing all facts most favorably for Harrison, here's what happened.

### *Dean Witter's Story*

Dean Witter's story begins back in mid-1983, when Kenning and Carpenter left the employ of a Florida branch of Prudential-Bache Securities, Inc. under questionable circumstances involving a failed complex securities transaction. Within weeks, a Dean Witter Florida branch office hired the two after conducting an investigation into the affair and after the New York Stock Exchange approved Kenning's application for transfer of his broker-dealer registration.

Richard Frost, the local Dean Witter branch manager, made Kenning a vice president and account executive. Carpenter, who was not registered, became Kenning's assistant and established an account in his own name at Dean Witter. Kenning controlled the account, and had Carpenter establish it primarily because Kenning was facing bankruptcy. Frost's signature was required on any order ticket for the account.

Carpenter and Kenning soon began accumulating huge sums in Carpenter's account by soliciting clients to become involved in municipal bond deals. They told their clients that the funds would be pooled and used to purchase these low risk bonds at substantially reduced prices and commissions—discounts available, they said, because they were Dean Witter employees and because of the large sums of money involved. As it turns out, however, Carpenter and Kenning did not invest in municipal bonds at all, but instead in high-risk put options.

Not only were Carpenter and Kenning lying about what they were doing, but they were blatantly violating Dean Witter rules prohibiting employees from commingling their own funds with client funds and from sharing an interest in an account with anyone other than a close relative. By August, 1984, Carpenter and Kenning had displayed an uncanny ability for losing money, having amassed nearly $600,000 in losses since starting with Dean Witter. In August, Dean Witter's regional manager, Haskell Adler, met with Kenning's former Prudential-Bache supervisor, who informed Adler that Kenning could not be trusted. Adler did nothing with the information.

In addition, on a number of occasions Alfred Rauschman, the head of Dean Witter's compliance department, contacted Frost to inquire about the heavy volume of trading taking place in Carpenter's account. Dean Witter's internal rules require supervisors to ensure that an employee's investments are commensurate with his resources. Frost questioned Carpenter and Kenning about their activities, but when Carpenter explained that the money was his own, Frost looked no further, demanding only that Carpenter have cash on hand for every purchase he made. Although Dean Witter rules prohibit employees from receiving checks in their own names, and require branch managers to screen all incoming and outgoing correspondences, Carpenter and Kenning avoided discovery of their scheme by having their clients send them money either at home or to their personal bank accounts.

By June, 1986, Kenning and Carpenter had amassed losses of more than $2,000,000 in the Carpenter account, as well as having paid substantial commissions to Dean Witter for the thousands of trades they had made. At this point, the house came tumbling down, with Kenning and Carpenter admitting their wrongdoing to their clients as well as Dean Witter.

### *Harrison's Story*

Harrison's story begins in February, 1985, with Kenning and Carpenter still actively engaged in their fraudulent scheme. At this time, Harrison, an Illinois millionaire with considerable investment experience, traveled to Florida with his friend, John Cahoon. There he met Carpenter for the first time and stayed at Carpenter's home. During the trip, Cahoon and Carpenter mentioned the bond deals which Carpenter and Kenning were offering to their larger clients. Before leaving Florida, Harrison expressed an interest in the deals.

Upon returning to Illinois, Harrison received a call from Kenning or Carpenter asking him if he wanted to participate in the bond deals. Over the next few weeks, the two Dean Witter employees spoke with Harrison on a number of occasions and explained that the bond deals would require Harrison to provide Kenning and Carpenter with funds which they would then place in their own accounts at Dean Witter. They would use these funds to purchase municipal bonds, nearing maturity, at a substantial discount. Harrison would earn some interest in the period before maturity, and then a large gain when the bonds were redeemed at par value. The discounts, the two told Harrison, were not available in transactions out of a customer's account.

Harrison made his first investment of $200,000 with Kenning and Carpenter on February 28, 1985, and over the next 16 months, 15 additional investments totaling approximately $2.8 million. Harrison also made two investments, totaling $1.1 million, out of HCI funds. At Carpenter's request, Harrison made two of these investments by wire transfer to Carpenter's personal checking account, and the rest by mailing checks to Carpenter at his home address.

In return for the investments, Carpenter and Kenning provided Harrison with what were fashioned to be personal promissory notes, but which Harrison believed were receipts for his bond purchases. The due dates of the notes generally coincided with the due dates of the bonds. The notes provided for Harrison to receive at the due date an interest rate commensurate with the return Harrison expected to receive on the bond deals. On an annualized basis, these notes contained interest rates ranging from approximately 18% to 60%. Dean Witter's name did not appear on any of the notes, and Harrison never received any confirmation or statement from Dean Witter regarding his investments with Kenning and Carpenter.

Through July, 1986 Carpenter repaid out of his personal checking account and in cash approximately $800,000 to Harrison and HCI. Harrison believed these payments represented profit generated from his interest in the municipal bonds, though Carpenter provided him with tax forms stating that Harrison and HCI had received interest income from Carpenter. Harrison also declared

$46,296.51 on his 1985 tax return as interest income on the monies he had given Carpenter for bond investments during 1985.

In July, 1986, Carpenter and Kenning flew to Illinois to inform Harrison that they had lost all of Harrison's money. When Harrison asked how they could have suffered such losses in municipal bonds, Carpenter informed him that they had been investing his money in far riskier instruments. Carpenter offered to establish a plan for repaying Harrison, but when he failed to produce such a plan in writing, Harrison sent letters to Carpenter and Kenning demanding immediate payment of all money due himself and HCI. Harrison did not notify Dean Witter of his losses, nor demand payment from Dean Witter, until he filed his lawsuit.

## DISCUSSION

Of the 11 counts remaining in Harrison's 12-count first amended complaint,[1] nine—one §10(b) claim, one RICO claim, and seven state law claims[2]—seek to impose liability against Dean Witter vicariously for the acts of Kenning and Carpenter. One claim, a negligence claim, alleges that Dean Witter itself—that is, Dean Witter's management level personnel, *see D&S Auto Parts, Inc. v. Schwartz,* 838 F.2d 964, 967-68 n.5 (7th Cir. 1988) violated Harrison's rights. And one claim, a §20(a) claim, involves a combination of the two. The court will address these theories of liability seriatim, cognizant of the fact that it may grant summary judgment for Dean Witter only if there remain no genuine issues of material fact requiring trial. Fed.R. Civ.P. 56(c).

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[1] In an earlier ruling, this court dismissed one of Harrison's two RICO claims, a §1962(c) claim, on the grounds that Dean Witter could not be held liable vicariously under this subsection for the acts of lower level employees such as Carpenter and Kenning. *Harrison v. Dean Witter Reynolds, Inc.*, No. 86 C 8003, slip op. (N.D. Ill. Sept. 9, 1988).

[2] The seven state law claims include: default on promissory notes; common law fraud; breach of fiduciary duty; breach of contract; breach of covenant of good faith; conversion; and violation of Florida law.

*Respondeat Superior*

Dean Witter does not deny that Kenning and Carpenter engaged in numerous illegal acts during the course of their employment with the securities firm. Under the common law doctrine of respondeat superior, Harrison may hold Dean Witter vicariously liable—that it, liable without fault—for its employees' violations of §10(b),[3] RICO,[4] and state law, provided that he can show either that Kenning and Carpenter had actually authority to do what they did, or that the two had the apparent authority to do it. *See generally Rosenthal & Co. v. Commodity Futures Trading Commission,* 802 F.2d 963 (7th Cir. 1986).[5] Whether they had such authority is a " '[question] of fact, to be decided by the trier of fact,' unless the relationship [or absence thereof] is 'so clear as to be undisputed.' " *Rankow v. First Chicago Corp.*, 870 F.2d 356, 359 (7th Cir. 1989) (quoting *St. Ann's Home for the Aged v. Daniels*, 95 Ill.App.3d 576, 579 (1981)).

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[3] Because §20(a) provides for a form of vicarious liability against securities firms, *see post* at [50-54], some courts have held that §20(a) precludes the application of common law respondeat superior. *See generally* Fitzpatrick & Carman, Respondeat Superior and the Federal Securities Laws: A Round Peg in a Square Hole, 12 Hofstra L.Rev. 1 (1983). The Seventh Circuit, however, has held that both §20(a) and common law vicarious liability principles apply in securities fraud cases. *Henrickson v. Henrickson*, 640 F.2d 880, 887 (7th Cir. 1981).

[4] In this court's earlier ruling, it was noted that the Seventh Circuit has created some ambiguity as to whether vicarious liability applies to §1962(a) claims. The court need not pursue this matter since, even if vicarious liability is available, Harrison cannot obtain it here.

### *a. Actual Authority*

Harrison first argues that Dean Witter may be held liable for the acts of Kenning and Carpenter because the two were authorized to sell municipal bonds to customers and that is precisely what they were doing. The fact that they subsequently misused the funds, Harrison contends, does not alter the fact that Kenning and Carpenter were doing what they were authorized to do.

Of course, Kenning and Carpenter were not really selling municipal bonds at all. But that is what they were offering to Harrison, and that is what he thought he was purchasing. Under settled principles of respondeat superior, an employee who does what he is authorized to do binds his employer even if the employee acts with an improper purpose and ultimately cheats both his employer and the third person. Restatement (Second) of Agency §165, Comment e; *id.* at §257, Comments a, d; *see Congregation of the Passion, Holy Cross v. Kidder Peabody & Co., Inc.*, 800 F.2d 177, 184 (7th Cir. 1986).

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[5] Although Dean Witter's vicarious liability for the state law claims is governed by Illinois law, whereas its vicarious liability under the federal claims would presumably be determined by federal principles, this court (as did the parties) will rely on federal and state cases interchangeably inasmuch as there is no discernible distinction among them on the legal issues presented here.

The flaw in Harrison's position, however, lies in the fact that Kenning and Carpenter were not authorized to sell municipal bonds in the manner they (purportedly) were selling them to Harrison, for Dean Witter's internal rules forbid employees from commingling their own funds with those of customers and from using customer funds to make purchases out of employee accounts. Had Dean Witter authorized its employees to offer bond deals of the sort Kenning and Carpenter were offering, it could not have escaped liability when the two misused Harrison's money. But because Dean Witter expressly prohibited these types of deals, Harrison cannot prevail under the principles of §165.

Still, the actual authority prong of the doctrine of respondeat superior goes further than §165. An employer is liable not only for acts it specifically authorizes its employee to do, but also for the acts of an employee within the scope of his employment. Restatement (Second) of Agency, §§216, 219(1); *see also Henrickson v. Henrickson*, 640 F.2d 880, 887-88 (7th Cir. 1981); *Lynch v. Board of Education*, 82 Ill.2d 415, 424-25 (1980).

In cases involving intentional wrongdoing, the scope of employment doctrine acquires something of an abstract quality, for such wrongdoing is never really within the scope of an employee's employment: if it were, then the employer's liability would be direct, not vicarious. *See* Restatement (Second) of Agency, §212 & Comment a; *cf. Pomer v. Deere & Co.*, No. 88 1794, slip op. at 7 (7th Cir. May 12, 1989). In determining whether an employer is liable for the wrongdoing of an employee, the analysis becomes one of degree: Just how related must the wrongdoing be to the nature of the employee's work before the wrongdoing itself falls within the scope of the employment?

In defining the boundaries of this doctrine, courts have looked to the rationales for it. These include: the equity consideration that the employer obtains benefits from the employee's legitimate work and thus should pay when the employee goes astray; the deterrence objective of providing employers with the incentive to keep their employees in line; and the compensatory function of imposing liability on the one, as between the innocent injured and the innocent employer, who can best absorb the costs of the employee's wrong. *See* W. Keeton, D. Dobbs, R. Keeton & D. Owen, *Prosser on Torts* §69, at 500-01 (5th ed. 1984); Restatement (Second) of Agency, §217, Comment a. The general rule is that an employee acts within the scope of his employment for respondeat superior purposes when his conduct "(a) . . . is of the kind he is employed to perform; (b) . . . occurs substantially within the authorized time and space limits; [and] (c) . . . is actuated, at least in part, by a purpose to serve the master . . . ." Restatement (Second) of Agency, §228; *Prosser on Torts*, *supra*, §70 at 502.

A jury could find that the acts of Carpenter and Kenning were of the kind they were hired to perform. Unlike §165, which provides for liability only when the act is specifically authorized by the employer, §229 of the Restatement provides that an act is of the kind an employee was hired to perform if the act is similar to those he was authorized to do and *inter alia*, if the employer "has reason to expect that such an act will be done." Restatement (Second) of Agency, §229(f); see *Rosenthal & Co. v. Commodity Futures Trading Commission*, 802 F.2d at 968-69. Thus, an act may be within the scope of employment even if it was specifically prohibited by the employer. Restatement (Second) of Agency, §230 ("An act, although forbidden, or done in a forbidden manner, may be within the scope of employment.");[6] *see Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 716 (2d Cir. 1980). Dean Witter hired Kenning and Carpenter to sell securities, and the facts suggest that it closed its eyes to the brokers' use of customer funds out of Carpenter's account.[7] These facts weigh in favor of finding the brokers' activities here to be within the scope of their employment.

What saves Dean Witter are the second and third elements in the analysis. Though Carpenter and Kenning received telephone calls at their office from Harrison, their relationship with Harrison took place primarily outside the office. Most significant, they received checks from him at home, received wire transfers to their personal bank accounts, and intentionally sought to avoid the oversight of Dean Witter supervisors. *See* Restatement (Second) of Agency, §234; *cf. Bolwin v. El Kay Manufacturing Co.*, 32 Ill.App.3d 138 (1975) (no respondeat superior liability where agency relationship was temporarily discontinued when tort occurred). Likewise, while Kenning and Carpenter paid commissions to Dean Witter out of the purchases they made with Harrison's money, no reasonable jury could find that they sought through their activities to benefit Dean Witter. On the contrary, their actions demonstrate a conscious plot to prevent Harrison from becoming a Dean Witter customer, and to use Harrison's funds for their own purposes. *See* Restatement (Second) of Agency, §235; Notes, Rule 10b—The Equivalent Scope of Liability under Respondeat Superior and Section 20(a)—Imposing a Benefit Requirement on Apparent Authority, 35 Vand.L.Rev. 1383, 1398 (1982) ("proper focus is upon the employee's state of mind"). Thus, even if a jury could find that the fraudulent scheme involved some activities of the kind Kenning and Carpenter were permitted to perform, it could not find that they were acting within the scope of their employment in the conduct of this scheme.

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[6] Dean Witter's reliance on *Old Security Life Insurance Company v. Continental Illinois National Bank*, 740 F.2d 1384 (7th Cir. 1984), proves only partially helpful here. Although the Seventh Circuit there stated that "[a]n agent has no authority to act contrary to the known wishes and instructions of his principal," *id.* at 1391, that case involved a contract-type claim and thus was subject to different vicarious liability standards than apply in cases involving tortious conduct. Thus, while the case does assist Dean Witter with respect to Harrison's contractual claims, it does not protect Dean Witter on the bulk of Harrison's complaint.

[7] Although Dean Witter's alleged negligence in not properly supervising Kenning and Carpenter is not relevant to the *respondeat superior* theories, the facts underlying this claim are relevant to the scope of the brokers' authority. A jury could find that Frost's minimal efforts to detect the source of their funds led them to believe that Dean Witter really did not care from where they got their money so long as they paid cash for each option purchase.

### *B. Apparent Authority*

When an employee acts outside the scope of his actual authority, his actions still may bind his employer if the employer "create[s] an appearance that the acts are authorized." *Rosenthal & Co. v. Commodity Futures Trading Commission*, 802 F.2d at 966. Actual authority depends on the employer's relationship with the employee. Apparent authority, by contrast, turns on the employer's relationship with the injured. Where the employer's actions give the injured reason to believe that the employee is acting within his authority, the employer is bound by the employee's acts even if the employee actually lacked such authority. See *American Society of Mechanical Engineers, Inc. v. Hydrolevel Corp.*, 456 U.S. 556, 565-68 (1982); Restatement (Second) of Agency, §261.

Harrison argues that Kenning and Carpenter had the apparent authority to offer the municipal bond deals on behalf of Dean Witter because they were Dean Witter employees, because they provided Harrison with a Dean Witter phone number at which to contact them, and because Dean Witter allowed the scheme to continue for a substantial period of time without notifying Harrison that something was amiss. He notes that an employer need have had no direct contact with the injured, so long as the authority he granted the employee reasonably suggest that the employee had the authority to do the unauthorized acts. *See Alterman v. Lydick*, 241 F.2d 50, 53 (7th Cir. 1957).

All this being true, Harrison cannot escape summary judgment here. An underlying predicate of any apparent authority theory is that " 'from the point of view of the third person the transaction seems regular on its face and the agent appears to be acting in the ordinary course of the business confided to him.' " *American Society of Mechanical Engineers, Inc. v. Hydrolevel Corp.*, 456 U.S. at 566 (1982) (quoting Restatement (Second) of Agency, §261, Comment a, p. 551). Apparent authority is an equitable doctrine designed to prevent injury to an innocent injured. When an individual has notice that an employee is exceeding the scope of his authority, the individual cannot rely on the employee's manifestations alone and then claim apparent authority. Restatement (Second) of Agency, §262 & Comment c; *see Holloway v. Howerdd*, 536 F.2d 690, 696 (6th Cir. 1976). He must undertake some reasonable efforts to determine whether the employee has the authority he says he does. *Evanston Bank v. Conticommodity Service, Inc.*, 623 F.Supp. 1014, 1032 (N.D. Ill. 1985).

Harrison's transactions with Kenning and Carpenter were anything but regular. Kenning and Carpenter told him that he could not open an account with Dean Witter, that he should mail or wire all payments to them personally, and that he would be receiving discounts available only to Dean Witter employees. Further, Harrison never received a single receipt, statement or other communication bearing a Dean Witter heading or the signature of anyone at Dean Witter. Thus, even if Harrison truly believed that he was a Dean Witter customer (and this much is open to serious question), he had an obligation to inquire further into the authority of Kenning and Carpenter to offer the bond deals on Dean Witter's behalf. Since he concedes that he did not do so, no reasonable jury could find Dean Witter liable under an apparent authority theory. Dean Witter is entitled to summary judgment on Harrison's respondeat superior claims.

### *Negligence*

Harrison predicates his negligence claim on Dean Witter's hiring and supervising of Kenning and Carpenter. According to Harrison, Dean Witter never should have hired the two brokers, and once it did, the firm should have supervised them to prevent them from defrauding Dean Witter customers. Dean Witter has moved for summary judgment on two grounds: that the Illinois economic loss doctrine precludes Harrison from bringing a negligence claim for his losses, and that, in any case, Dean Witter had no duty to Harrison because he was not a Dean Witter customer.

### *a. The Economic Loss Doctrine*

Dean Witter contends that Harrison may not pursue his negligence claim because he seeks to recover purely economic losses—i.e., the money he invested with Carpenter and Kenning plus interest—and Illinois prohibits suing in tort for such losses. Harrison disagrees, arguing that the Illinois economic loss doctrine does not apply to the negligent performance of professional services.[8]

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[8] Harrison also makes two other arguments against the application of the economic loss doctrine here, but neither merits much discussion. First, he argues (without citation) that he is seeking damages beyond mere economic loss because, in addition to profits, he requests the recovery of funds invested with Dean Witter. Yet, *Rankow v. First Chicago Corp.*, 870 F.2d 356 (7th Cir. 1989), held that precisely such damages were economic losses within the scope of the doctrine. *See also First National Bank of Boston v. Hitoshi Une*, No. 87 C 10831, 1988 U.S.Dist LEXIS 13416 (N.D. Ill. 1988) (money extended as credit, both principal and interest, fall within economic loss doctrine); *Bane v. Ferguson*, 707 F.Supp. 988, 998 (N.D. Ill. 1989). Second, he argues that claims of negligent misrepresentations against those in the business of supplying information do not fall within the doctrine. This is true (see the discussion in the text below), but does not help Harrison since he is not suing Dean Witter for making negligent misrepresentations.

In *Moorman v. National Tea Company*, 91 Ill.2d 69 (1982), the plaintiff sued the manufacturer under strict liability, innocent misrepresentation, and negligence when a steel grain storage tank developed a large crack. The Illinois Supreme Court dismissed all three claims, holding that a plaintiff suing for economic losses—i.e., " 'damages for inadequate value, costs of repair and replacement of the defective product, or consequent loss of profits—without any claim of personal injury or damage to other property,' " *id.* at 82 (quoting Note, Economic Loss in Products Liability Jurisprudence, 66 Colum.L. Rev. 917, 918 (1966)—generally must bring his claims in contract rather than tort. The Court, however, noted two kinds of cases in which the recovery of economic loss had been permitted: "where one intentionally makes false representations (*Soules v. General Motors Corp.*, 79 Ill.2d 282 (1980)), and where one who is in the business of supplying information for the guidance of others in their business transactions makes negligent representations. (*Rozny v. Marnul*, 43 Ill.2d 54)." *Moorman*, 91 Ill.2d at 88-89.

*Moorman* was a products liability action, and was predicated, at least in part, on the extensive framework the Uniform Commercial Code provides for dealing with economic losses caused by defective products (*see id.* at 78-79, 88). But after the Court applied the doctrine to non-UCC cases, see *Redarowitz v. Ohlendorf*, 92 Ill.2d 171 (1982) (purchaser of a home could not sue the builder in tort for economic losses resulting from defects in the home's construction); *accord Morrow v. L.A. Goldschmidt Associates, Inc.*, 112 Ill.2d 87 (1986), a number of Illinois appellate courts read Moorman broadly as barring all tort claims for economic loss except those specifically excepted in *Moorman*. Since claims against professionals usually seek only economic loss—rarely does professional misconduct cause personal injury or property damage—these courts have barred most actions against professionals for negligent performance of their services. *See, e.g.*, *People ex rel. Skinner v. Graham*, 170 Ill.App.3d 417 (4th Dist. 1988); *Bates & Ropers Construction Corp. v. North Shore Sanitary District*, 128 Ill.App.3d 962 (2d Dist. 1984), *aff'd on other grounds*, 109 Ill.2d 225 (1985).

This view of the economic loss doctrine derives from the Illinois Supreme Court's failure to tie its doctrine into the traditional elements of tort liability. To recover in tort, a plaintiff always has had to establish three things: duty; breach of duty; and damages. W. Keeton, D. Dobbs, R. Keeton & D. Owen, *Prosser on Torts* §30, at 164-65 (5th ed. 1984). Most courts, including the United States Supreme Court, have prohibited claims for economic loss on the ground that a manufacturer has no extra-contractual duty to prevent economic loss. *See East River Steamship Corp. v. Transamerica Delavel, Inc.*, 476 U.S. 858, 871 (1986). Had the Illinois Supreme Court framed the doctrine as such, it would have made clear that where the law imposes extra-contractual duties, a breach of those duties can give to liability in tort even if the only losses are purely economic ones.

The Illinois Court, however, has not explained its doctrine in this way. Instead, it has suggested the prohibition on economic loss arises not because the defendant had no tort duty to avoid such loss, but simply because contract, rather than tort, provides a more appropriate framework for dealing with economic loss. This approach takes tort and contract as mutually exclusive, *see* Bertschy, The Economic Loss Doctrine in Illinois After *Moor-*

*man*, 71 Ill.B.J. 346, 351 (1983)—ignoring the fact that in some circumstances an individual's duties extend beyond the contours of his contractual relationship—and would bar most professional negligence claims. *See Anderson Electric Company, Inc. v. Ledbetter Erection Corporation*, 115 Ill.2d 146 (1986) (Simon, J., specially concurring) (criticizing majority's exclusive focus on the nature of the loss).

Of course, if the Illinois Supreme Court truly meant to preempt all tort claims for economic loss—except in the two classes of cases set forth in *Moorman*—then federal courts have no authority to overrule this approach in diversity cases. But the Court never actually has ruled that the doctrine extends to cases in which the defendant has extra-contractual duties, *see Bates & Rogers Construction Corp. v. Greeley & Hansen*, 109 Ill. 2d 225, 229 (1985) (declining to decide whether doctrine barred negligence claim against professional architect); *Ferenchak v. Village of Frankfort*, 105 Ill.2d 474, 479 (1985) (same for civil engineer), and two factors indicate that it did not intend for the doctrine to go that far.

First, the view that the two exceptions set forth in *Moorman*—i.e., claims of intentional misrepresentation, and of negligent misrepresentation by those in the business of supplying information—are the exclusive exceptions to the doctrine provides no rationale for why they should be so. Any justification for these exceptions—for example, that even a manufacturer has a duty to avoid intentionally misrepresenting his product—implies that the exceptions are merely illustrative of a broader set of cases in which applying the doctrine would be inappropriate. *See, e.g., Waldinger Corp. v. CRS Group Engineers, Inc.*, 775 F.2d 781 (7th Cir. 1985) (*Moorman* does not bar claims for intentional interference with contractual relationship); *accord Santucci v. Baxter and Woodman*, 151 Ill.App.3d 547, 553 (1984).

Second, and more important, to hold that *Moorman* bars tort claims for economic loss even where the defendant has extra-contractual duties "would, simply by inference, effectively eliminate and stand squarely in conflict with the body of law defining the scope" of professional liability. *Rosos Litho Supply Corporation v. Hansen*, 123 Ill.App.3d 290, 295 (1st Dist. 1984). A number of Illinois and federal courts have declined to read *Moorman* that broadly for precisely this reason, *see id.*; *People ex rel. Skinner v. FGM, Inc.*, 166 Ill.App.3d 802 (5th Dist. 1988); *Kishwaukee Community Health Services Center v. Hospital Building and Equipment Co.*, 638 F.Supp. 1492 (N.D. Ill. 1986), and at least one Illinois Supreme Court case lends support to this view.

In *Pelham v. Griesheimer*, 92 Ill.2d 13 (1982), a case decided just a few months after Moorman, the Court made no mention of the economic loss doctrine in ruling that, under certain circumstances, a non-client could sue an attorney for negligence. *See also Ogle v. Fuiten*, 112 Ill.App.3d 1048 (4th Dist. 1983). Since the damages in such a case would almost always constitute economic loss, this ruling strongly suggests that the Court did not even consider that the economic loss doctrine would serve as a bar to professional negligence claims. *See Dundee Cement Co. v. Chemical Laboratories, Inc.*, 712 F.2d 1166 (7th Cir. 1983).

Limited to their holdings, the Illinois Supreme Court's economic loss doctrine cases provide a coherent philosophical and practical statement regarding the duties of manufacturers and other providers of tangible products:

Whereas they have a societal obligation to prevent physical injury and damage to other property, and a duty as well to refrain from intentional misrepresentations, their obligations with respect to their products are primarily contractual. *Cf. Pippin v. Chicago Housing Authority*, 78 Ill.2d 204, 209 (1979) (scope of duty in voluntary undertaking is limited by contractual relationship). To extend the doctrine to claims of professional negligence, however, deprives the doctrine of its coherence. Why a professional who violates his extra-contractual obligations should gain immunity from liability merely because the damage he causes is economic finds no explanation in the cases and stands at odds with long-established law. *See* Hnatt, Purely Economic Loss: A Standard for Recovery, 73 Iowa L. Rev. 1181, 1198 (1988). Absent a clear message from the Illinois Supreme Court, this court can find no basis for extending the doctrine this far. Because Dean Witter implicitly has conceded that it is a provider of professional services, *cf. Rankow v. First Chicago Corp.*, 870 F.2d 364-65 (7th Cir. 1989), it cannot escape liability on the basis alone that Harrison's losses were purely economic.

*b. Duty*

Dean Witter next argues that it is entitled to summary judgment because it had no duty to prevent harm—economic or otherwise—to Harrison. Harrison has responded with evidence that Dean Witter knew or should have known that Kenning and Carpenter were investing out of Carpenter's personal account more money than the two could afford. In light of Kenning's prior problems at Prudential-Bache, this evidence creates a genuine factual dispute as to whether Dean Witter likewise should have been alerted to the possibility that Kenning and Carpenter wrongfully were obtaining funds from outside sources. Yet, even if Dean Witter knew that Kenning and Carpenter were committing fraud, this knowledge alone is not enough to subject it to liability; Dean Witter must have had a duty to intervene on Harrison's behalf. *Homer v. Pabst Brewing Co.*, 806 F.2d 119, 121 (7th Cir. 1987; *see generally* W. Keeton, D. Dobbs, R. Keeton & D. Owen, *Prosser on Torts* §53 (5th ed. 1984). Whether Dean Witter had such a duty is an issue of law. *Ferenchak v. Village of Frankfort*, 105 Ill.2d 474, 480 (1985).

Although the foreseeability of injury is an important consideration in determining whether one has a duty to act reasonably with respect to another, it is not alone. *Kirk v. Michael Rees Hospital & Medical Center*, 117 Ill. 2d 507 (1987). Instead, four factors come into play: "(1) whether the occurrence or accident was foreseeable; (2) the likelihood of injury; (3) the magnitude of the burden of guarding against that injury from occurring; and (4) the consequence of placing that burden upon the defendant." *Salvi v. Montgomery Ward & Co.*, 140 Ill.App.3d 896 (1986); *Barnes v. Washington*, 56 Ill.2d 22, 29 (1973). In cases where it is alleged that one person failed to prevent a third person from doing harm to another, the last two factors usually take precedence over the first two. That is, while wrongdoing may be foreseeable, and injury likely, the law generally imposes no duty to prevent such harm because the burden on the defendant of imposing such a duty outweighs the benefits of doing so. *See Heldt v. Brei*, 118 Ill.App.3d 798, 802 (1983); Restatement (Second) of Torts, §314; W. Keeton, D. Dobbs, R. Keeton & D. Owen, *Prosser on Torts* §56, at 376 (5th ed. 1984).

Every rule has exceptions; this rule has two. A person who knows or has reason to know that a third person may cause harm to another has an obligation to protect the other if (1) the person has a special relation with the third person or (2) the person has a special relation with the other. *See* Restatement (Second) of Torts §315; generally W. Keeton, D. Dobbs, R. Keeton & D. Owen, *Prosser on Torts* §56, at 383-85 (5th ed. 1984). In the employer-employee context, both exceptions may come into play: An employer may have a duty to prevent employee wrongdoing because of the employer's relationship with the employee, and it may have a duty to prevent such wrongdoing because of its relationship with certain members of the public—i.e., its customers.

Harrison fails to specify the basis for his allegation that Dean Witter had a duty to prevent Kenning and Carpenter from injuring him. Instead, he argues that Dean Witter had a broad duty to prevent any employee from harming any member of the public. This is not so. *See Capalbo v. Paine Webber, Inc.*, 672 F.Supp. 1048, 1054 (N.D. Ill. 1987).

The employee-employer relationship imposes a duty on an employer to prevent employee misconduct when the employee is located on employer's premises or using the employer's property in furtherance of the wrong. *See* Restatement (Second) of Torts §317; *Gregor v. Keliser*, 111 Ill.App.3d 333 (1983). The mere fact that an employer has knowledge of an employee's delinquent tendencies, however, does not impose a duty on the employer to fire or otherwise sanction the employee so long as the employee does his thing outside the employer's premises and without the aid of the employer's property. *See* Restatement (Second) of Torts §317, Comment b; *Roberson* *v. Allied Foundry and Machinery Co.*, 447 So.2d 720 (Ala. 1984); *cf. Insurance Co. of North America v. Hewitt-Robbins, Inc.*, 13 Ill.App.3d 534 (1973).

Kenning and Carpenter committed their fraud without the use of Dean Witter property. They did not give Harrison a Dean Witter contract, did not provide him with Dean Witter receipts, and did not pay him with Dean Witter checks. Nor did the two commit the fraud on Dean Witter's premises: Although they conversed with Harrison over the phone from Dean Witter's offices, the fraud occurred when Harrison either mailed checks to their homes or wired money to their personal accounts. Dean Witter's relationship with the two therefore did not obligate it to discover and terminate their fraud on Harrison.

An employer also has a duty to prevent employee wrongdoing when the employer has a contractual relationship with a customer which facilitates the employee's wrong. *See generally* Restatement (Second) of Agency §213. Thus, for example, if an employer contracts to provide moving services to a customer, it may be liable if an employee robs the customer during the move. *Becken v. Manpower, Inc.*, 532 F.2d 56 (7th Cir. 1976). And if an employer undertakes to provide security services to a customer, the employer may be liable if its employees use the employer's special privileges to enter the premises as part of a burglary scheme. *International Distributing Corp. v. American Distributors*, 569 F.2d 136 (D.C. Cir. 1977); *see also Welsh Manufacturing, Division of Textron, Inc. v. Pinkerton's Inc.*, 474 A.2d 436 (R.I. 1984).

Dean Witter and Harrison, however, had no relationship. To be sure, Harrison may have believed that he was a Dean Witter customer, but Dean Witter's duty to control the activities of its employees vis-a-vis its customers extends only so far as its contract with those customers. As already discussed, Dean Witter did not have a contractual relationship with Harrison. It therefore had no obligation to protect them from the wrongdoing of Dean Witter employees. Accordingly, Dean Witter is entitled to summary judgment on Harrison's negligence claim.

*Section 20(a)*

In addition to *respondeat superior* and common law negligence, Congress has provided an alternative basis for imposing liability on securities firms in §10(b) claims. Section 20(a) of the Securities Exchange Act of 1934 provides:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. §78t(a).

Liability under §20(a) is both broader and narrower than liability under common law *respondeat superior.* The controlled person need not be an employee or agent of the defendant for the defendant to be subject to liability for wrongdoing, so long as the defendant exercised some control over the wrongdoer with respect to the wrongful acts. *Christoffel v. E.F. Hutton & Co., Inc.*, 588 F.2d 665, 668 (9th Cir. 1978). On the other hand, §20(a), unlike *respondeat superior*, allows the defendant to escape liability if it can show that it acted in good faith and did not induce the misconduct. *See generally* Notes, Rule 10b-5—The Equivalent Scope of Liability under Respondeat Superior and Section §20(a)—Imposing a Benefit Requirement on Apparent Authority, 35 Vand.L.Rev. 1383, 1400-04 (1982).

Before examining Dean Witter's potential liability under §20(a), it is first necessary to identify the underlying violation, since without such a primary violation there can be no secondary liability, *Bosio v. Norbay Securities*, 599 F.Supp. 1563, 1570 (E.D.N.Y. 1985), and since Dean Witter can be held liable only for the wrongful acts of Kenning and Carpenter over which it exercised control, *Sennott v. Rodman & Renshaw*, 474 F.2d 32, 39-40 (7th Cir. 1973).

Dean Witter begins by arguing that there was no §10(b) violation at all. Under §10(b), fraud is actionable only if it is "in connection with the purchase or sale of [a] security." 15 U.S.C. §78j(b).[9] Dean Witter contends that the fraud here was not in connection with the purchase of municipal bonds because Kenning and Carpenter never actually purchased the bonds. This case, Dean Witter says, involves a conversion of funds, nothing more, and conversion does not give rise to a §10(b) claim, see *Crummere v. Smith, Barney, Harris, Upham & Co., Inc.*, 624 F.Supp. 751, 755 (S.D.N.Y. 1985); *Smith v. Chicago Corp.*, 566 F.Supp 66 (N.D. Ill. 1983).

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[9] Section 10 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange—
>
> . . . .
>
> (b) To use or employ, in connection with the purchase and sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as

(continued...)

Harrison does not take issue with Dean Witter's argument on this score.[10] Instead, Harrison argues that the securities here were the promissory notes Kenning and Carpenter gave to Harrison when he provided them with funds to purchase municipal bonds. Dean Witter, though noting that Harrison's position marks a sharp shift from his earlier argument that the notes were nothing more than receipts, concedes that these notes are securities for §10(b) purchases.

Harrison's victory, however, is short-lived. Having established that Kenning and Carpenter committed fraud in connection with their sales of these notes, he now must show that Dean Witter exercised control over the two brokers with respect to these sales. This he cannot do.

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[9] (...continued)

> necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. §78j(b).

[10] Because of Harrison's implied concession, this court need not and does not decide whether Dean Witter is correct in arguing that Kenning and Carpenter did not violate §10(b) by investing in options rather than in municipal bonds.

Although *respondeat superior* and §20(a) are not coextensive, so that an employee may act outside the scope of his employment and yet still be a controlled person under §20(a), courts have agreed that employment alone does not bring every one of an employee's acts within the coverage of the statute. *See Carpenter v. Harris, Upham & Co.*, 594 F.2d 388 (4th Cir. 1979); *Christoffel v. E.F. Hutton & Co., Inc.*, 588 F.2d 665 (3d Cir. 1978); *cf. Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490 (7th Cir. 1986). Section 20(a) requires, at least, that the firm have the ability directly or indirectly to influence the employee's doing of the specific unlawful act—for example, to prohibit the act from taking place on the employer's property. Where the employee's wrongdoing involves acts unrelated to his employment, his employer cannot be held liable on the grounds alone that it could have fired him had it known of the wrongdoing. *Christoffel v. E.F. Hutton & Co., Inc.*, 588 F.2d 665, 669 (3d Cir. 1978); *see also Bradshaw v. Van Houten*, 601 F.Supp. 983, 986-87 (D. Ariz. 1985).

Dean Witter exercised no control over Kenning and Carpenter with respect to their sales of promissory notes. It did not know of these sales, nor could it have known of them, since Carpenter and Kenning structured their arrangement with Harrison to ensure that Harrison would not send any money to them at the office. Further, the sales were conducted in the names of Kenning and Carpenter alone; the payments on the notes were by Carpenter's personal checks; and Harrison never contacted Dean Witter to inquire about his investments.

Dean Witter had an obligation to supervise Kenning and Carpenter at the office. It had obligations to ensure that Dean Witter's customers were not being defrauded by the two brokers, and to investigate any signs of wrongdoing with regard to the brokers' job-related activities. But those obligations did not extend to the brokers' personal affairs. Harrison could have brought himself within the protections of §20(a) by insisting on receipts and statements bearing Dean Witter's name. Instead, he chose to enter into transactions which any reasonable person, indeed any rational person, would have to conclude were personal transactions between himself and Kenning and Carpenter. Dean Witter's responsibilities under §20(a) simply did not reach that far. The firm is therefore entitled to summary judgment on Harrison's §20(a) claim.

## CONCLUSION

Dean Witter's motion for summary judgment is granted on each count in the complaint. Judgment is entered for Dean Witter.

ENTER:

BRIAN BARNETT DUFF, JUDGE,
UNITED STATES DISTRICT COURT

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

Name of Assigned Judge: BRIAN BARNETT DUFF

Case Number: 86 C 8003 Date: June 28, 1989

Case Title: Hudson T. Harrison v.
Dean Witter Reynolds, Inc.

* * * * *

DOCKET ENTRY:

(1) ☐ Judgment is ordered as follows:
(2) ☒ [Other docket entry:]

Dean Witter's motion for summary judgment is granted on each count in the complaint. Judgment is entered for Dean Witter.

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